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99TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPT. 99-426

TAX REFORM ACT OF 1985

REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ON

H.R. 3838

together with

DISSENTING AND ADDITIONAL DISSENTING VIEWS

DECEMBER 7, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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99TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPT. 99-426

TAX REFORM ACT OF 1985

DECEMBER 7, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 3838]

together with

DISSENTING AND ADDITIONAL DISSENTING VIEWS

The Committee on Ways and Means, to whom was referred the bill (H.R. 3838) to reform the internal revenue laws of the United States, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

55-103 O

I. LEGISLATIVE BACKGROUND

This bill, H.R. 3838, was introduced and ordered favorably reported on December 3, 1985, after almost a year-long comprehensive review in the 99th Congress by the committee and subcommittees in public hearings and markup consideration. This has been the most extensive review of internal revenue laws since enactment of the 1954 Code. In light of this fact, this tax reform bill redesignates the Internal Revenue Code of 1954 as the Internal Revenue Code of 1985.

Committee Hearings

The full committee held 30 days of public hearings on comprehensive tax reform proposals. The committee began public hearings on comprehensive tax reform proposals on February 27, 1985. Committee hearings on tax reform issues continued on March 26; May 30; June 4, 5, 7, 11-14, 17, 18, 20, 24-27; and July 8-12, 17, 19, 22, 25, 26, 29-31. A committee hearing also was held on May 16, on proposed technical corrections to the Deficit Reduction Act of 1984 (H.R. 1800) and to the Retirement Equity Act of 1984 (H.R. 2100).

Included in the committee's tax reform hearing consideration this year was the President's tax reform proposal made in May 1985 ("The President's Tax Reform Proposals to the Congress for Fairness, Growth, and Simplicity").

Subcommittee Hearings

Several Subcommittee hearings were held during 1985 that relate to subject matters included in H.R. 3838.

Subcommittee on Select Revenue Measures.—The Select Revenue Measures Subcommittee held hearings on the following areas:

March 19—Targeted jobs tax credit
April 1, 2, 16—Acquisitions and mergers (with Oversight Subcommittee)
April 25—Attorney's fees
May 22—Carryover of net operating losses (NOLs)
June 6—Tax burdens of low-income wage earners

Subcommittee on Oversight.—The Oversight Subcommittee held hearings on the following areas:

June 21—IRS taxpayer refund delays
July 18, September 5, 6—Retirement income security (with Social Security Subcommittee)
August 1—Tax-exempt multifamily housing bonds
September 19—Tax refund offsets to collect non-tax Federal debts
September 20—High-income taxpayers and partnership tax issues

Committee Markup

The committee conducted 26 days of markup on the tax reform bill: beginning on September 18; continuing on September 26, 30, October 1-4, 7-9, 11, 15, 23, 25-27, November 6, 15-17, 19-23; and concluding on December 3 when the tax reform bill, H.R. 3838, was introduced and ordered favorably reported. There was also a committee markup on technical corrections to 1984 tax legislation on September 27, which is included as a separate title XV to this bill.

II. SUMMARY OF THE BILL

Title I. Individual Income Tax Provisions

A. Basic Rate Structure

1. Rate reductions

The bill provides a new 4-bracket tax rate schedule based on taxable income, which will become effective on July 1, 1986. The Secretary of the Treasury is instructed to prepare blended tax schedules for 1986 tax returns which will incorporate half of the present law structure (as indexed for inflation) and half of the new tax rate structure. The new tax rate structure, which will be fully effective on January 1, 1987, is shown below.

Tax rates (%)	Taxable income			
	Married couples & surviving spouses	Heads of households	Unmarried individuals	Married individuals filing separately
15	Not over $22,500	Not over $16,000	Not over $12,500	Not over $11,250
25	22,500–43,000	16,000–34,000	12,500–30,000	11,250–21,500
35	43,000–100,000	34,000–75,000	30,000–60,000	21,500–50,000
38	Over 100,000	Over 75,000	Over 60,000	Over 50,000

The taxable income amounts in the rate schedules is indexed for inflation beginning in 1987.

2. Increase in standard deduction

The standard deduction replaces the zero bracket amount. Effective in 1987, the standard deduction amounts are $4,800 for joint returns of married couples and for surviving spouses, $4,200 for heads of households, $2,950 for unmarried individuals, and $2,400 for married individuals filing separate returns. These amounts are indexed for inflation beginning in 1988.

An additional standard deduction amount of $600 is allowed for an elderly or blind individual. For these taxpayers only, the new standard deduction amount and the additional $600 standard deduction amount are effective on January 1, 1986.

For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for 1986 are $3,670 for joint returns, $2,480 for heads of households and single persons, and $1,835 for married individuals filing separately.

Individuals who itemize deductions will reduce their total itemized deductions by $500 times the number of personal exemptions claimed.

3. Increase in personal exemption

The personal exemption is raised to $2,000 for each individual, individual's spouse, and dependent, effective January 1, 1986. (The additional exemption under present law for a blind or elderly individual is repealed.) The personal exemption amount is indexed for inflation beginning in 1987.

4. Two-earner deduction

The deduction for two-earner married couples is repealed after December 31, 1985. Adjustments made in the standard deduction for married couples filing joint returns and in the relationship of the rate schedules for unmarried individuals and married couples filing joints returns compensate for the repeal of this provision.

B. Individual Tax Credits

1. Earned income credit

Currently, an eligible individual is allowed a refundable income tax credit equal to 11 percent of the first $5,000 of earned income, for a maximum credit of $550. The maximum allowable credit is phased down, however, as adjusted gross income (or, if greater, earned income) rises above $6,500. Also, the credit is not allowed for taxpayers with adjusted gross income (AGI) or, if greater, earned income over $10,000. Currently, the credit is not adjusted for inflation.

The bill increases the maximum allowable credit to 14 percent of the first $5,000 of earned income (for a maximum credit of $700), for taxable years beginning on or after January 1, 1986. The phaseout levels for 1986 are adjusted so that the credit phases out between $6,500 and $13,500 of AGI. For taxable years beginning on or after January 1, 1987, the phaseout of the credit begins at $9,000 of AGI; it is totally phased out at $16,000 of AGI. Also, the maximum amount of the credit and the phaseout income levels are adjusted for inflation.

2. Repeal of political contributions credit

The tax credit allowed to individuals under present law for one-half the amount of contributions to political candidates and certain political campaign organizations, up to a maximum of $50 ($100 on a joint return), is repealed. The repeal is effective for taxable years beginning after December 31, 1985.

C. Provisions Related to Exclusions

1. Limit on exclusion for child care assistance

The bill limits the exclusion for employer-provided child care assistance to $5,000 a year ($2,500 in the case of a married individual filing separately), effective for taxable years beginning after December 31, 1985.

2. Unemployment compensation benefits

Under present law, a portion of unemployment compensation benefits is includible in gross income if the sum of the recipient's benefits and adjusted gross income exceeds specified amounts. The

bill provides that all unemployment compensation benefits are includible in gross income, for taxable years beginning after December 31, 1985.

3. Scholarships and fellowships

The bill limits the exclusion for degree candidates to the amount of a scholarship or fellowship grant required to be used for tuition and fees, books, supplies, and equipment required for courses. The bill repeals the exclusion for grants received by nondegree candidates, but does not affect whether their unreimbursed educational expenses may be deductible as trade or business expenses. The bill also provides that the exclusion does not apply to any portion of amounts received as a scholarship or a tuition reduction which represents payment for teaching, research, or other services required as a condition of receiving the grant. The bill repeals the present-law exclusion for certain Federal grants where the recipient is required to perform future services as a Federal employee. The provision is effective for scholarships and fellowships granted after September 25, 1985.

4. Exclusion for prizes and awards

The exclusion for certain prizes and awards is repealed, except where the winner assigns the award to charity (see also the description above of the scholarship exclusion). Awards by employers to employees are includible in income unless qualifying for the present-law exclusion for de minimis items (such as certain traditional retirement gifts). The provision applies to taxable years beginning after December 31, 1985.

D. Individual Deductions

1. Employee expenses and miscellaneous itemized deductions

A one-percent floor is placed under itemized deductions for miscellaneous employee, investment, and certain other expenses, and nonreimbursed employee travel and other expenses that presently are deductible "above-the-line" are included in the miscellaneous itemized deduction. The provision is effective for taxable years beginning after December 31, 1985.

2. Charitable contribution deduction for nonitemizers

The bill makes permanent the deduction for charitable contributions made by individuals who do not itemize deductions. The bill modifies the deduction by providing that for taxable years beginning after 1985, the deduction is subject to a $100 floor.

3. Adoption expenses

Currently, an individual is allowed an itemized deduction for up to $1,500 of expenses incurred in the adoption of certain handicapped ("special needs") children. The bill repeals this deduction for taxable years after December 31, 1986, and modifies the Adoption Assistance Program of Title IV-E of the Social Security Act to provide assistance through that program for such adoption expenses (see also Title XIV, item 7.)

E. Other Provisions

1. Income averaging

The income averaging provision is repealed, effective for taxable years beginning after December 31, 1985.

2. Travel and entertainment expenses

The bill provides that 80 percent of meal and other entertainment expenses, to the extent otherwise allowable, can be deducted. Certain legal and substantiation requirements are added for business meal deductions. Deductions for tickets are limited to face value, and luxury "skybox" deductions are restricted. No deductions are allowed for travel as a form of education, charitable travel that serves vacation purposes, or expenses for attending investment seminars. Deductions for luxury water travel are limited. The provision applies to taxable years beginning after December 31, 1985.

3. Changes in treatment of hobby losses

Under present law, an activity other than horse breeding, training, showing, or racing is presumed not to be a hobby if it is profitable in 2 out of 5 consecutive years. Under the bill, the presumption is changed so that an activity (other than one involving horses) is presumed not to be a hobby if it is profitable in 3 out of 5 consecutive years. The provision is effective for taxable years beginning after December 31, 1985.

4. Deduction for business use of home

The bill makes several changes regarding limitations on deductions for business use of one's home. First, no deduction arises for costs associated with business use of the home (except for items allowable without reference to such use, e.g., home mortgage interest) in the case of an employee who rents a portion of the home to the employer. Second, home office costs are deductible only to the extent of net income from the business activity (rather than certain gross income, as under present law). Third, deductions disallowed because in excess of such net income can be carried forward. The provision is effective for taxable years beginning after December 31, 1985.

5. Housing allowances for ministers and military personnel and deductions for property taxes and mortgage interest

The bill provides that the receipt of tax-free housing allowances by ministers or military personnel does not result in loss of deductions for interest or real property tax on the individual's home, effective for past and future years.

Title II. Capital Income Provisions

A. Cost Recovery Provisions

1. Depreciation

Incentive depreciation.—The Accelerated Cost Recovery System is replaced by the Incentive Depreciation System (IDS), effective generally for property placed in service after December 31, 1985, except for property covered by transition rules.

IDS groups assets into ten classes, generally according to their present class life (or "ADR midpoint life"). Assets in the same IDS class are depreciated over a common period, ranging from 3 to 30 years. The 200-percent declining balance method, switching to the straight-line method, is used for classes 1-9; the straight-line method is used for class 10, which includes primarily real property other than low-income housing.

Inflation adjustments.—IDS deductions are subject to increases for inflation adjustments, beginning in 1988. In general, the adjustments are for half the inflation rate in excess of 5 percent in applicable years.

Nonincentive depreciation.—A nonincentive depreciation system applies for assets used abroad or by tax-exempt entities, for minimum tax purposes, and for certain other purposes. Depreciation under this system is generally straight-line over an asset's present class life (40 years for real property).

Expensing.—The current $5,000 limit on the amount of personal property that may be expensed annually is raised to $10,000, and expensing is available only to taxpayers whose qualified expenditures do not exceed $200,000 for the taxable years.

2. Regular investment tax credit

Repeal.—The regular investment tax credit is repealed, effective generally for property placed in service after December 31, 1985.

Transition rules.—The credit is available for eligible property to which transition rules apply for depreciation purposes. Such credits are generally allowed ratably over a 5-year period, and a full adjustment in depreciable basis for the entire credit is required when property is placed in service.

3. Finance leasing

Finance leasing is repealed, effective for property placed in service after December 31, 1985, subject to transition rules.

B. Limitation on General Business Credit

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the general business credit is reduced from 85 percent to 75 percent.

C. *Rapid Amortization Provisions*

The bill repeals rapid amortization elections for certain costs relating to trademarks and trade names, certified pollution control facilities, and qualified railroad grading and tunnel bores, generally effective for expenditures paid or incurred after December 31, 1985. Transitional rules are provided with respect to certain binding contracts.

The bill retains and makes permanent the present law election to amortize over 60 months certain qualifying costs for rehabilitation of low-income housing. The bill replaces the present law limit of $20,000 per dwelling unit ($40,000 in some cases) with a single $30,000 per dwelling unit limit. The bill also extends for two years the present law election to expense qualified expenditures to remove architectural and transportation barriers to the handicapped and elderly.

The bill provides for a two-year extension (through 1987) of the present-law provision that allows the expensing of costs attributable to the removal of architecural and transportation barriers to the hadicapped and elderly.

D. Other Capital-Related Costs

1. Incremental research credit

The bill extends the credit for increasing research activities for an additional three years, i.e., for qualified research expenditures paid or incurred through December 31, 1988. In addition, the bill modifies the credit as follows, effective for taxable years beginning after 1985:

(a) The credit rate is reduced from 25 percent to 20 percent.

(b) Rental and similar payments for the use of personal property are not eligible for the credit, except for certain payments for computer time.

(c) The committee report modifies the definition of qualified research for purposes of the extended credit.

(d) Increased tax incentives are provided for corporate cash expenditures in excess of certain floors for basic research at universities and certain other organizations.

(e) The general limitation on use of business credits (under the bill, 75 percent of tax liability over $25,000) applies to the research credit.

2. Donations of scientific equipment

The present-law rule allowing an augmented charitable deduction for donations of newly manufactured scientific equipment to universities for research use is extended to such donations made to certain tax-exempt scientific research organizations, effective for taxable years beginning after 1985.

3. Tax credit for rehabilitation expenditures

The bill replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for expenditures incurred in rehabilitation of certified historic structures and 10 percent for rehabilitation of buildings (other than certified historic structures) built

before 1936. In general, the bill retains the structure of the existing rehabilitation credit, except the external walls requirement is tightened in the case of non-historic buildings and relaxed in the case of certified historic structures. In addition, the bill requires a basis adjustment for the full amount of the rehabilitation credit in the case of both historic and non-historic buildings.

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1985.

4. Merchant Marine Capital Construction Fund

The Merchant Marine Act of 1936, as amended, provides Federal income tax incentives for U.S. taxpayers who own or lease vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. The bill coordinates the application of the Internal Revenue Code of 1985 with the capital construction fund program of the Merchant Marine Act of 1936, as amended. In addition, new requirements are imposed, relating to (1) the tax treatment of nonqualified withdrawals, (2) certain reports to be made by the Secretaries of Transportation and Commerce to the Secretary of the Treasury, and (3) a time limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose.

These rules are effective for taxable years beginning after 1985.

E. Capital Gains and Losses

1. Individual long-term gains

The bill provides a deduction for 50 percent of long-term capital gain for taxable years beginning in 1986 and 42 percent for taxable years beginning after 1986. In conjunction with the changes in the top regular individual rates, this produces a maximum long-term capital gain tax rate of 22 percent for taxable years beginning in 1986 (50 percent of 44 percent) and 22.04 percent thereafter (58 percent of 38 percent).

These provisions apply to capital gain reportable under the taxpayer's method of accounting in taxable years beginning after 1985, regardless of whether the sale or other transaction giving rise to the gain occurred in a prior year.

2. Royalty income from coal and domestic iron ore

The bill phases out the special capital gain rules for coal and domestic iron ore royalties over a three year period, beginning January 1, 1986. The provision applies to royalties taken into account after 1985.

3. Recapture of certain amounts previously reducing taxable income

The bill expands the amount of gain that must be treated as ordinary income on the disposition of oil, gas or geothermal property to include the amount of depletion deductions that have previously reduced basis, in addition to the excess intangible drilling costs which are recaptured under present law. The bill applies similar rules for mining exploration and development costs. The new provi-

sions generally apply to property placed in service by the taxpayer after 1985.

F. *Oil, Gas and Geothermal Properties*

1. Intangible drilling and development costs

Under present law, intangible drilling and development costs (IDCs) generally may be expensed or capitalized at the election of the operator of an oil, gas or geothermal property. IDCs qualify for this treatment whether incurred in the United States or in a foreign country. In the case of integrated producers, 80 percent of IDCs may be expensed and the remaining 20 percent must be amortized over a 36-month period. Costs with respect to a nonproductive well ("dry hole") may be deducted by any taxpayer in the year the dry hole is completed.

Under the bill, domestic IDCs that are incurred prior to the beginning of the installation of production casing may be expensed as under present law. (For integrated producers, 80 percent of these IDCs may be expensed and the remaining 20 percent must be amortized over a 36-month period). IDCs associated with the installation of production casing, or that are incurred after the commencement of such installation, are to be amortized over a 26-month period, beginning with the month in which the costs are paid or incurred. (This rule does not apply below the lowest production level.) Unamortized IDCs associated with dry holes may be expensed in the year in which the dry hole is completed. These rules apply to oil, gas and geothermal properties.

IDCs incurred outside the United States are to be recovered (i) using 10-year, straight-line amortization, or (ii) at the taxpayer's election, as part of the basis for cost depletion.

These provisions are effective for costs paid or incurred after 1985.

2. Percentage depletion

Present law allows percentage depletion for up to 1,000 barrels of daily crude oil production (or the equivalent amount of natural gas) by an independent producer or royalty owner. The percentage depletion rate for oil and gas is equal to 15 percent of the taxpayer's gross income from the property, not to exceed (1) 50 percent of net income from the property, or (2) 65 percent of the taxpayer's overall taxable income. Percentage depletion is also allowed at a 15 percent rate for geothermal properties.

The bill generally phases out percentage depletion for oil, gas and geothermal properties over a three-year period. Taxpayers will thereafter be required to use the cost depletion method. Percentage depletion is retained at a 15 percent rate for stripper well oil (as defined for purposes of the crude oil windfall profit tax) and gas (as defined under the Natural Gas Policy Act of 1978). No percentage depletion is allowed for lease bonuses, advance royalties, or any other amounts payable without regard to the actual production from an oil, gas or geothermal property.

The phaseout of percentage depletion applies to production after December 31, 1985 (in the case of geothermal properties, in taxable years beginning after that date). The denial of percentage depletion

for lease bonuses and advance royalties is effective on January 1, 1986.

3. Windfall profit tax exemption for certain exchanges of crude oil

The bill provides that certain crude oil is exempt from the crude oil windfall profit tax if it is exchanged for an equal amount of residual fuel oil which is be used on the property in enhanced recovery processes. This exception is limited to production attributable to an operating mineral interest. No depletion deduction (including cost or percentage depletion) is available with respect to oil qualifying for this exception. The exception is applicable to residual fuel used, and crude oil removed, after the date of enactment.

G. Hard Minerals

1. Depletion

Under present law, acquisition and related costs of mineral deposits must be recovered in any taxable year through cost or percentage depletion, whichever results in a larger deduction for that year. Depletion rates range from 5 to 22 percent of gross income. The depletion deduction for any property may not exceed 50-percent of net income from the property.

For most minerals, the bill ratably phases down the depletion rate to 5 percent over 3 years. In the case of minerals that have a 5-percent depletion rate under present law, the bill ratably phases down the depletion rate to zero over 3 years. Present law depletion rates are retained for dimension stone and minerals used in the production of fertilizer or animal feed. The 50 percent income limitation ratably is phased down to 25 percent over 3 years.

The phase down of depletion rates is effective for production after December 31, 1985. The phase down of the income limitation is effective for tax years beginning after 1985.

2. Exploration and development costs

Under present law, hard mineral exploration and development costs may be expensed by individual taxpayers. In the case of corporations, 80 percent of these costs may be expensed, and the remaining 20 percent is recovered in the same manner as 5-year depreciable property. At the taxpayer's election, once a mine begins production, expensed exploration (but not development) costs either (1) reduce depletion deductions, or (2) are recaptured in income and then recovered through depletion deductions.

Under the bill, the treatment of development costs generally is conformed to the treatment of exploration costs under present law. For domestic mines, development costs that are expensed would be recaptured when the mine reaches the producing stage. Recaptured amounts (and development costs incurred after production commences) would be recovered in the same manner as depreciable property in class 1 (3-year recover period). (Alternatively, these amounts could be applied to reduce depletion deductions.) The 20 percent of corporate exploration and development costs that are not expensed would be recovered in the same manner as class 2

property (5-year recovery period), beginning in the year the costs are paid or incurred.

In the case of foreign mines, exploration and development costs are recovered by (1) 10-year straight-line amortization or (2) at the election of the taxpayer, as part of the basis for cost depletion.

These provisions are effective for costs paid or incurred after December 31, 1985.

H. Energy and Fuels Tax Provisions

1. Residential tax credits.—The solar energy tax credit is extended for three years at reduced credit rates—30 percent in 1986 and 20 percent in 1987 and 1988. Expenditures for solar hot water property are limited to $5,000. The credit may not be used to create a sun room, greenhouse, or similar structure. The insulation, energy conservation, and wind energy tax credits are allowed to expire at the end of 1985.

2. Business tax credits.—Business solar and geothermal energy tax credits are extended for three years at reduced credit rates; solar credits will be 15 percent in 1986, 12 percent in 1987, and 8 percent in 1988; geothermal credits will be 15 percent in 1986 and 10 percent in 1987 and 1988. The other business energy tax credits are allowed to expire as scheduled in present law; these credits covered wind energy, ocean thermal energy and biomass properties, intercity buses, and small-scale hydroelectric projects.

3. Tax credit for fuels from nonconventional sources.—Production credits for fuels from nonconventional energy sources are repealed after 1985, except for fuels produced from wells drilled or facilities placed in service before January 1, 1986, and sold before January 1, 1990. An exception is made for methane gas produced from wood in facilities placed in service before January 1, 1990, and sold before January 1, 2001.

4. Alcohol fuels.—The 9-cents-per-gallon exemption from the gasoline and motor fuels excise taxes for neat alcohol and methanol fuels is reduced to 6 cents per gallon. The 60-cents-per-gallon nonrefundable income tax credit for blending alcohol with gasoline is repealed after December 31, 1985. The 6-cents-per-gallon excise tax exemption for gasohol is unchanged from present law.

5. *Taxicab fuel tax exemption.*—The 4-cents-per-gallon exemption from the excise taxes on gasoline and motor fuels for qualified taxicabs is reinstated as of October 1, 1985 for three years, through September 30, 1988.

I. Extension of Certain Tax Credits

1. Extension and modification of targeted jobs tax credit

Under present law, the targeted jobs credit is available with respect to individuals who begin work for the employer before 1986. The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. A credit equal to 85 percent of the first $3,000 of qualified first-year wages of any disadvantaged summer youth employee is also allowed.

The bill extends the targeted jobs credit for two more years with several modifications. The bill eliminates the credit for second-year wages, reduces the first-year credit to 40 percent of the first $6,000 of qualified first-year wages (except in the case of disadvantaged summer youth employees), eliminates the credit for wages paid to an individual who works for the employer for fewer than 14 days, and extends the authorization for appropriations for administrative and publicity expenses through fiscal year 1987. Under the bill, the credit is available for wages paid to individuals who begin work for an employer before 1988. The amendments to the targeted jobs credit rules apply to taxable years beginning after 1985.

2. Orphan drug tax credit

The income tax credit for clinical testing of orphan drugs is extended for one additional year through December 31, 1988.

Title III. Corporate Taxation

A. Corporate Tax Rates

The bill provides a 3-bracket graduated corporate rate structure as follows:

Taxable income:	*Tax rate (percent)*
$50,000	15
Over $50,000 but not over $75,000	25
Over $75,000	36

This structure reduces from 5 to 3 the number of corporate income tax brackets, and lowers from 46 to 36 the tax rate applicable to large corporations. The benefit of graduated rates is phased out for corporations with more than $365,000 of taxable income (compared to $1,405,000 under present law).

The 28-percent alternative tax rate for net capital gains of corporations is increased to 36 percent—the regular tax rate applicable to large corporations.

The graduated income tax rates are effective for tax years beginning on or after July 1, 1986. The rate schedule for taxable years including July 1, 1986 will reflect blended rates.

The increase in the alternative tax rate on corporate capital gains generally is effective for tax years ending after December 31, 1985. Under a transition rule, the present maximum 28-percent rate will apply to net capital gain recognized before January 1, 1986 or pursuant to a binding contract in effect on September 25, 1985.

B. Dividends Paid Deduction

The bill generally gives corporations a deduction for 10 percent of dividends paid out of corporate earnings that have been subject to tax. The deduction is not available for RICs, REITs, S corporations, cooperatives, and DISCs or FSCs, which are otherwise subject to special tax regimes. Compensatory shareholder-level taxes are imposed in certain circumstances on foreign shareholders and on tax-exempt shareholders holding 5 percent or more of the payor's stock.

The deduction is available for taxable years beginning after January 1, 1987 and is phased in over a ten-year period.

C. Dividends Received Deduction

The 85 percent dividends received deduction under present law is reduced to 80 percent for dividends received after December 31, 1985. In addition, the dividends received deduction is adjusted to reflect the phase in of the dividends paid deduction. Thus, for example, the 80 percent dividends received deduction is reduced to 79

percent in the first year that the dividends paid deduction is available, and to 70 percent after the ten year phase in.

D. Dividend Exclusion for Individuals

The $100 dividends exclusion for individuals ($200 for a joint return) is repealed, effective for taxable years beginning after December 31, 1985.

E. Clarification of Nondeductibility of Stock Redemption expenses

The bill clarifies present law by providing that no amount paid or incurred by a corporation in connection with a redemption of its stock is deductible or amortizable. This would preclude, for example, deduction of so-called "greenmail" payments made to stockholders to avert a hostile takeover.

F. Special Limitations on Net Operating Loss and Other Carryforwards

The bill alters the character of the special limitations on the use of net operating loss (NOL) and other carryforwards. After a change in ownership of more than 50 percent of the value of stock in a loss corporation, however effected, the taxable income available for offset by pre-acquisition NOLs is limited to the long-term tax-exempt rate times the value of the loss corporation's equity. In addition, NOLs are disallowed unless the loss corporation satisfies the continuity-of-business-enterprise rule that applies to tax-free reorganizations for the two-year period following an ownership change, regardless of the type of transaction that results in the change of control. The bill also expands the scope of the special limitations to include built-in losses and takes into account built-in gains. The bill includes a number of rules designed to ensure the limitations accomplish their intended objectives and makes other changes to present law, of a more technical nature, including rules relating to the measurement of beneficial ownership. The bill applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Effective dates.—In general, the bill applies to changes in ownership that occur after December 31, 1985 (unless pursuant to plans of tax-free reorganization adopted before January 1, 1986).

G. Recognition of Gain and Loss on Liquidating Distributions and Sales of Property (Repeal of the *General Utilities* Rule

The bill provides that, in general, gain or loss is recognized to a corporation on a distribution of its property in complete liquidation, as if it had sold the property at fair market value. This repeals the so-called *General Utilities* rule. An exception is provided for distributions to certain controlling corporate shareholders. An exception is also provided for distributions to certain noncorporate, long-term shareholders, under rules similar to those applicable to nonliquidating distributions under present law. Under either exception, nonrecognition is available only to the extent of the qualifying shareholders' percentage interest in the liquidating corporation. The amount subject to nonrecognition is generally this percentage of gain or loss on each asset distributed, without regard to the status of the actual distributee.

Under the bill, nonrecognition is also allowed on certain liquidating sales of property to the same extent nonrecognition would have been available had the property been distributed.

Effective dates.—In general, the bill applies to distributions and sales and exchanges occurring on and or after November 20, 1985. An exception is provided in the case of certain distributions and sales made pursuant to a plan of liquidation adopted before that date. Special rules apply for purposes of determining whether a plan of liquidation has been adopted for this purpose.

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Title IV. Tax Shelters

A. At-Risk Rules

The at-risk rules limit the net losses which individuals and certain corporate taxpayers may deduct with respect to an activity. Present law provides an exception from the rules for the activity of holding real estate. The bill repeals this real estate exception. However, a taxpayer will be at risk for certain unrelated third-party nonrecourse debt incurred with respect to real estate. The provision is effective for losses attributable to property acquired after December 31, 1985.

B. Investment Interest Limitation

1. General limitation.—The deduction for nonbusiness interest expense of noncorporate taxpayers, in excess of their net investment income, is the sum of (a) interest on debt secured by the taxpayer's principal residence, as well as a second residence, to the extent of their fair market value, plus (b) $10,000 ($20,000 for a joint return).

2. Interest subject to limitation.—Nonbusiness interest subject to the limitation means all interest (including consumer interest) not incurred in a trade or business, including the taxpayer's share of interest expense attributable to certain passive investments.

3. Investment income defined.—Net investment income includes dividends, interest, rents, royalties, and similar items, the taxpayer's share of income attributable to certain passive investments and the taxable portion of capital gains. Investment expenses, which are netted against this income to determine net investment income, include expenses and depreciation and depletion actually deducted.

4. Net leases.—Property subject to a net lease is considered an investment, unless the business deductions exceed 15 percent of the rental income. If the taxpayer performs personal services with respect to certain leased property, the value of his services may be included with his business deductions, in calculating 15 percent of rental income.

Effective date.—Subject to a phase-in rule, the limitation will be effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred. Interest not disallowed under present law, but which would disallowed under the bill, would become subject to disallowance ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, the provision will be fully effective in 1995.

Title V. Individual and Corporate Minimum Taxes

A. Individual Minimum Tax

The present law individual alternative minimum tax is retained with the following modifications. The rate is increased to 25 percent; incentive depreciation on all property placed in service after 1985 is a preference; certain timing preferences (such as depreciation) are measured for post-1985 property on an aggregated basis, instead of measuring them item-by-item without netting; the maximum rate on capital gains is 22 percent and certain transfers by insolvent farmers are excluded; the net income offset to the intangible drilling cost preference is reduced to 65 percent; and the following new preferences are added: interest on newly issued nonessential function bonds, excludable income earned abroad by U.S. citizens, the benefit of the completed contract method of accounting, excludable income of foreign sales corporations (FSCs), losses in excess of twice the cash basis in passive farming activities, net losses in excess of certain cash basis in passive investment activities (with a $50,000 limit for losses from tax shelters), and charitable contributions of appreciated property (to the extent of the taxpayer's other preferences). In addition, a credit is allowed against the regular tax for prior years' minimum tax liability attributable to timing preferences. The provision applies to taxable years beginning after December 31, 1985.

B. Corporate Minimum Tax

An alternative minimum tax, similar to the individual minimum tax, replaces the present law add-on tax. The rate is 25 percent, and a $40,000 exemption is allowed. The items of tax preference include the corporate preferences under present law, incentive depreciation on all property placed in service after 1985 (with taxpayers being required instead to use the nonincentive rules for minimum tax purposes), intangible drilling costs (with the same 65 percent net income offset applying to individuals), tax-exempt interest on nongovernmental obligations, excludable FSC income, the benefit of the completed contract method of accounting, and charitable contributions of appreciated property (to the extent of the taxpayer's other preferences). Rules similar to those under the alternative minimum tax on individuals apply to incentive credits, the foreign tax credit, and net operating losses. A credit for the minimum tax paid in earlier year is allowed against the regular tax. Estimated tax payments are required with respect to corporate minimum tax liability. The provision applies to taxable years beginning after December 31, 1985.

Title VI. Foreign Tax Provisions

A. Foreign Tax Credit

1. Foreign tax credit limitation.—The overall foreign tax credit limitation of present law is retained. The separate limitation for interest income is replaced with separate limitations for passive income, shipping income, foreign currency translation gain, and banking and insurance income. Passive income includes certain categories of income subject to current taxation under the anti-tax haven rules.

These rules are effective for taxable years beginning after 1985.

2. Creditability of gross withholding taxes on interest.—Foreign gross withholding taxes on interest paid to financial institutions are treated as creditable taxes only up to the amount of the U.S. tax on the interest income.

This provision is generally effective for taxes paid in taxable years beginning after 1985, but certain transition relief is provided.

3. Deemed-paid credit.—(a) The deemed paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation is determined with respect to the foreign corporation's multi-year pool of accumulated earnings and profits; and (b) earnings and profits generally are computed in the same manner for actual distributions as they are now for tax-haven income inclusions.

These rules are generally effective for earnings and profits accumulated in taxable years beginning after 1985.

4. Effect of losses on foreign tax credit.—Present law is generally retained with a clarification that foreign source losses reduce all types of foreign source income before reducing U.S. source income.

This provision applies to losses incurred in taxable years beginning after 1985.

B. Source Rules

1. Income derived from purchase and sale of inventory-type property.—Source is generally determined by the country of residence of the seller (the place-of-title-passage source rule of present law is repealed). When a seller has a fixed place of business outside his residence country that participates materially in a sale to an unrelated party, the sales income generally is sourced in the country in which that fixed place of business is located.

2. Income from manufacture and sale of inventory-type property.—At least 50 percent of such income must be allocated to manufacturing activity, which is sourced where the manufacturing occurs. The portion of such income allocated to sales activity is sourced under the rules for sales income described immediately above.

3. Income from intangible property.—With respect to royalty income, the bill retains the place-of-use source rule of present law. With respect to sales income, the bill generally follows the rule, de-

scribed above, for income from the purchase and sale of inventory-type property, which generally depends upon the residence of the seller.

4. Income derived from sale of other personal property.—Under the bill, recapture income derived from sales of personal property used by the seller in a business is sourced where deductions with respect to such property previously offset income. Income in excess of those deductions is sourced like income from sales of inventory-type property. Income derived from sales of other personal property, including passive investment property, is sourced in the country of residence of the seller.

5. Transportation income.—The bill sources transportation income from United States-foreign routes as 50-percent U.S. source income and 50-percent foreign source income. (Present law generally treats most transportation income earned on such routes as foreign source income.) The special U.S. sourcing rule for income and expenses associated with vessels or aircraft constructed in the United States and leased to U.S. persons is repealed. The bill also repeals a similar rule for transportation income earned in leasing certain aircraft used on United States-U.S. possessions routes. The repeal of both special rules is subject to a grandfather rule for currently leased assets.

Under the bill, the reciprocal tax exemption for foreign persons' shipping and aircraft income is available only if a foreign person's country of residence gives U.S. persons an equivalent foreign tax exemption; in addition, a four-percent gross basis tax is imposed on U.S. source shipping income of foreign persons.

6. Other offshore income and income earned in space.—The bill sources other offshore income and income earned in space in the recipient's country of residence.

7. Dividend and interest income.—For withholding tax purposes, the bill generally treats interest paid to unrelated parties by a U.S. corporation that earns more than 80 percent of its income from foreign sources (an "80/20" company) as foreign source to the extent that the company's income is derived from foreign sources in the active conduct of a trade or business outside the United States. Dividend and other interest payments to foreigners by an 80/20 company are generally subject to U.S. withholding tax. For foreign tax credit purposes, the bill treats 80/20 companies' dividends as U.S. source, and their interest payments as U.S. source unless they are connected with an active financing business of an unrelated U.S. payee conducted outside the United States. The bill also restructures certain interest income exemptions.

8. Allocation of interest and other expenses.—The bill generally requires corporate members of affiliated groups to allocate all expenses between U.S. and foreign income on a consolidated group basis. Certain corporations that cannot join in filing consolidated returns can continue to allocate expenses on a separate company basis, as can some financial and similar companies, if their borrowing and lending activities are independent from their affiliates' other operations. The asset method of allocating interest expense is modified and the optional gross income method is eliminated. Tax-exempt income and assets are not taken into account for purposes of allocating expenses. The new interest allocation rules will be

phased in over three years in the case of interest paid on preexisting debt amounts. Other transitional relief is provided.

9. Allocation of R&D expenses.—For two years, taxpayers are to allocate half the expenses for U.S.-performed R&D to U.S. source income, and the other half on the basis of sales or gross income. After two years, starting with taxable years beginning after August 1, 1987, a suspended Treasury Regulation generally requiring allocation on the basis of sales or gross income will take effect.

Effective date.—The rules governing the source of income are generally effective for taxable years beginning after 1985, although the bill provides certain transitional relief.

C. U.S. Taxation of Income Earned Through Foreign Corporations

1. Tax haven income generally.—Interest, dividends, and gains received by banks and insurance companies, insurance income, income earned in space or outside any country, base company rents and royalties, and gains from transactions in commodities, foreign currency, and certain other property generally are taxed currently if earned by controlled foreign corporations. Certain exceptions to the Code's rules that currently tax certain "tax-haven" income of foreign subsidiaries of U.S. companies are repealed, including the exclusion for reinvested shipping income. The subjective tax-avoidance safe-harbor rule is replaced with an objective test.

2. Determination of U.S. control of foreign corporations.—The U.S. ownership requirement for imposition of the anti-tax haven rules is amended. For the anti-tax haven rules to apply to a foreign corporation, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of that corporation must belong to 10-percent U.S. shareholders. Similarly, for the foreign personal holding company rules to apply, 50 percent or more of the vote or value of a foreign corporation must be owned by five or fewer U.S. individuals. Transitional relief is provided.

3. De minimis tax haven income rule.—Present law is amended to apply the de minimis and 70-percent rules for foreign base company income on the basis of earnings and profits instead of gross income.

4. Foreign investment companies (FICs).—Present law is amended to require either current recognition of income earned by U.S. investors through passive FICs or payment of an interest charge on eventual recognition, and to apply FIC rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. Transitional relief is provided.

5. Possessions-chartered corporations.—The exception to the anti-tax haven rules for possessions-chartered corporations is repealed, with appropriate transition rules provided.

Effective date.—The bill's rules applicable to income earned through foreign corporations are generally effective for taxable years beginning after 1985.

D. Special Tax Provisions for U.S. Persons

1. Possession tax credit and income from intangibles

a. Possession tax credit.—The bill retains the existing possession tax credit with certain modifications. The optional cost sharing

method of allocating intangible income is changed to require that the cost sharing payment be determined as the greater of (1) 110 percent of the payment determined under present law and (2) an arm's-length royalty. The bill also requires an increase in the cost-sharing payment (20 percent above the present law payment) for purposes of the 50/50 profit split method. The active income test for possession corporation status is increased from 65 to 75 percent over 2 years. Certain passive income derived from loans made by the Government Development Bank of Puerto Rico in qualifying Caribbean Basin countries are tax-exempt in the hands of companies operating in the possessions. Identical rules apply to U.S. operations in the U.S. Virgin Islands.

b. Income from intangibles.—The payment for intangibles received from foreign corporations by related U.S. persons must be commensurate with the actual income attributable to the intangible.

Effective date.—These rules generally apply to taxable years beginning after 1985. However, the rule that looks to actual income attributable to an intangible applies to intangibles transferred after November 16, 1985.

2. Other rules with respect to U.S. possessions

a. U.S. Virgin Islands.—The Virgin Islands will continue to use the mirror code. The Virgin Islands inhabitant rule is repealed. To be exempt from U.S. withholding tax, 65 percent of a Virgin Islands corporation's income must be effectively connected with a trade or business in a possession or in the United States. Anti-abuse rules are provided.

b. Guam, the Commonwealth of the Northern Mariana Islands (CNMI), and American Samoa.—After 1985, full authority will be granted to Guam and the CNMI to determine their own income tax laws (as American Samoa currently does). To avoid U.S. withholding tax, 65 percent of a possession corporation's income must be effectively connected with a trade or business in a possession or in the United States. Anti-abuse rules are provided.

Effective date.—The bill's rules coordinating United States and possessions taxation generally apply to taxable years beginning after 1985, or as soon as the applicable possession agrees to cooperate with the United States in tax matters.

3. Taxation of U.S. employees of Panama Canal Commission

The bill clarifies that the Panama Canal Treaty and its implementing agreements do not exempt U.S. taxpayers from U.S. tax. The bill provides that Commission employees are entitled to certain tax-free allowances like those available for State Department employees.

The bill's clarification of the effect of the Panama Canal treaty is effective for all taxable years. The rule concerning taxation of employees' allowances applies for taxable years beginning after 1985.

4. Foreign Sales Corporations (FSCs)

The bill changes the reduction in taxable income for FSC shareholders from 16 percent to 14 percent of export income (from 15 percent to 13 percent for corporate shareholders). Corresponding

changes are made to DISC rules. This provision is effective for taxable years beginning after 1985.

5. Private sector earnings of Americans abroad

The bill reduces the maximum annual exclusion for foreign earned income of Americans working abroad, from the present $80,000 to $75,000. The provision is effective for taxable years beginning after 1985.

E. Foreign Taxpayers

1. Branch-level tax.—The branch-level tax proposed by the President as a substitute for the present dividend and interest withholding taxes is generally adopted. The bill retains present law when a treaty allows present law to apply but would not allow a branch-level tax to apply. The bill provides anti-treaty shopping rules. These rules are effective for taxable years beginning after 1985.

2. Retain character of effectively connected income.—The bill treats income or gain as effectively connected with a U.S. trade or business if it is attributable to a different taxable year and would have been so treated if it had been taken into account in the other year. This rule applies to taxable years beginning after 1985.

3. Application of accumulated earnings tax (AET) and personal holding company (PHC) tax to foreign corporations.—Present law is amended to allow foreign corporations a net capital gain deduction for purposes of calculating the AET or PHC tax only if the gains are taxed by the United States at the corporate level. This provision applies to transactions occurring after November 15, 1985.

4. Tax-free exchanges by expatriates.—The tax-avoidance expatriate rules under present law are applied to gains on the sale of property the basis of which was determined by reference to U.S. property. This rule applies to sales or exchanges of property received in exchanges after September 25, 1985.

5. Excise tax on insurance premiums paid to foreign insurers.—The bill makes the excise tax on casualty reinsurance premiums paid to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (4 percent), makes the foreign insurer liable for the tax, and requires the U.S. insured or broker obligated to transmit the premiums to withhold the tax. This rule applies to premiums paid after 1985.

F. Foreign Currency Exchange Gain or Loss

The tax treatment of exchange gain or loss, including character, source, and timing, is clarified. Generally, exchange gain or loss arises if the exchange rate fluctuates between the date an item is taken into account for tax purposes and the date it is paid. In general, exchange gain or loss is ordinary in nature. To the extent provided by regulations, a special rule will require a taxpayer to recognize gain or loss currently with respect to an item that is "hedged" by an offsetting position (e.g., a foreign currency futures contract). All business entities that account for foreign operations in a foreign currency are generally required to use a profit and loss translation method. For purposes of the foreign tax credit, a foreign tax is translated at the exchange rate in effect on the payment date. The indirect foreign tax credit is calculated on the basis of the ex-

change rate in effect on the date the tax was paid or accrued by the subsidiary, and the exchange gain or loss on the distributed earnings is treated as separate basket foreign source income or loss.

Effective date.—These rules are effective for taxable years beginning after 1985.

Title VII. Tax-Exempt Bonds

A. Tax-Exempt Bond Provisions

1. General restrictions on tax-exemption

Interest on State and local government bonds used to finance traditional government operations is tax-exempt. Interest on bonds to provide conduit financing for nongovernmental persons is taxable unless a specific exception is provided in the Code. A bond generally is viewed as for nongovernmental conduit financing if (a) more than 25 percent of the proceeds are used in a trade or business of a nongovernmental person (and a security interest test is satisfied), or (b) an amount equal to 5 percent or more of the bond proceeds is used to finance loans to such a person.

The bill provides that bonds are for nongovernmental conduit financing if either (a) an amount equal to or exceeding the lesser of 10 percent or $10 million of bond proceeds is used in a trade or business of a nongovernmental person or (b) an amount equal to or exceeding the lesser of 5 percent or $5 million of bond proceeds is used to finance loans to such a person. Bonds for governmental activities are referred to collectively as *essential function bonds* under the bill.

2. Exceptions for certain nonessential function bonds

Present law includes several exceptions permitting tax-exemption for interest on bonds for nongovernmental conduit financing. These exceptions are for (a) industrial development bonds (IDBs); (b) student loan bonds issued in connection with certain Department of Education guarantees; (c) qualified mortgage bonds and qualified veterans' mortgage bonds; (d) bonds for section 501(c)(3) organizations; and (e) certain bonds issued under non-Code statutes enacted before 1984, if the bonds satisfy all Code requirements for bonds the proceeds of which are used for a comparable activity.

The bill continues many of the exceptions permitting tax-exempt financing for activities of nongovernmental persons. Bonds for these activities are referred to collectively as *nonessential function bonds*. Activities for which nonessential function bonds may be issued are (a) exempt-facility bonds (bonds for airports, docks and wharves, mass commuting facilities, certain water furnishing facilities, sewage and solid waste disposal facilities, and qualified multifamily residential rental projects); (b) qualified mortgage bonds and qualified veterans' mortgage bonds; (c) qualified small-issue bonds; (d) section 501(c)(3) organization bonds; (e) qualified student loan bonds (expanded to include certain bonds not issued in connection with Department of Education guarantees); and (f) qualified redevelopment bonds. Additionally, the bill retains the option for States and local governments to elect to exchange qualified mortgage bond authority and issue mortgage credit certificates.

3. Unified State volume limitation

Present law provides three separate State volume limitations for (a) IDBs and student loan bonds, (b) qualified mortgage bonds, and (c) qualified veterans' mortgage bonds. Certain types of IDBs and bonds for secton 501(c)(3) organizations are not subject to State volume limitations.

The bill provides a unified State volume limitation for all nonessential function bonds and the nongovernmental portion (in excess of $1 million) of essential function bonds. States (and local issuers therein) may issue an aggregate annual amount of such bonds not exceeding the greater of $175 per resident of the State or $200 million.

An amount equal to $25 per capita ($30 million in the case of a State having a $200 million volume limitation) is permanently set-aside for section 501(c)(3) organization bonds. Additional set-asides are provided for bonds to finance housing and for qualified redevelopment bonds; these additional set-asides may be overridden by State legislation. Bonds for certain airport, dock, and wharf facilities are not subject to this volume limitation. In general, the new unified volume limitation is administered in a manner similar to the present-law volume limitations on IDBs and student loan bonds and on qualified mortgage bonds.

4. Arbitrage restrictions

Interest on arbitrage bonds is taxable under present law. Arbitrage bonds are bonds more than a minor portion of the proceeds of which are invested in materially higher yielding obligations. IDBs and qualified mortgage bonds are subject to additional arbitrage restrictions that require rebates to the Federal Government of arbitrage profits on obligations unrelated to the purpose of the borrowing and restrict the amount of bond proceeds that may be invested in such obligations.

The bill makes numerous technical amendments to the general arbitrage restrictions presently applicable to all tax-exempt bonds; extends to all such bonds both a requirement that certain arbitrage profits be rebated to the Federal Government and a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations; restricts or prohibits advance refundings of all tax-exempt bonds; and restricts the early issuance of tax-exempt bonds; and provide that the purchase of annuity contracts with bond proceeds to fund pension plans will be subject to arbitrage restrictions in the same manner as if bond proceeds were used directly to fund such plans.

5. Modification and extension of miscellaneous restrictions

The bill extends to all nonessential function bonds present law requirements applicable to certain types of such bonds that require (a) that all net proceeds of the bonds be used for the exempt purpose of the borrowing; (b) that the maturity date of the bonds not exceed 120 percent of the economic life of any bond-financed property; (c) that substantial users of bond-financed facilities not own the bonds used in the financing; and (d) that certain public approvals occur before issuance of the bonds.

6. Changes in use of bond-finance facilities

The bill provides that in addition to loss of tax-exemption on bond interest where provided under present law, certain amounts paid in connection with bond-financed property that ceases to be used in a use qualifying for tax-exempt financing many not be deducted for Federal income tax purposes. In general, the nondeductible amount is the interest (or the equivalent thereof) paid on bond-financed loans.

7. Ownership and cost recovery deductions for bond-financed property

The bill requires certain facilities financed with tax-exempt bonds to be owned by or on behalf of a governmental unit. Exceptions are provided for sewage and solid waste disposal facilities, for qualified multifamily residential rental projects, for bond-financed owner-occupied residences, and for property financed with qualified redevelopment bonds and small-issue bonds. Additionally, facilities financed with section 501(c)(3) organization bonds may be owned either by a section 501(c)(3) organization or a governmental unit. The determination of ownership is made using general Federal income tax concepts.

Cost recovery deductions for bond-financed property generally are determined using the straight-line method and the recovery period for property in the next higher class of property under the new depreciation system included in the bill. Costs of real property are recovered over a 40-year period. Special recovery periods and methods are provided for qualified multifamily residential rental property.

8. Information reporting requirements

The bill extends to all tax-exempt bonds information reporting requirements similar to the requirements that presently apply to IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and tax-exempt mortgage subsidy bonds.

9. Effective dates

The provisions of the bill generally apply to all bonds issued after December 31, 1985. Transitional exceptions are provided for certain of the amendments included in the bill.

B. General Stock Ownership Corporations (GSOCs)

The bill eliminates the Code provisions relating to General Stock Ownership Corporations as deadwood, effective upon enactment.

Title VIII. Financial Institutions

A. Reserve for Bad Debts

1. Commercial banks.—Commercial banks may continue to compute their deductions for losses on bad debts under present law, except in the case of "large banks." "Large banks" must use the specific charge off method to compute the deduction for bad debts. A bank is considered to be a "large bank" if, for any taxable year beginning after 1985, the sum of the average adjusted bases of the assets of the bank (or of the assets of any controlled group to which the bank belongs) exceeds $500 million. Large banks required to change their method of accounting for bad debts are required to recapture the balance in reserve for bad debts over a period not to exceed five years, or are required to account for bad debts on existing loans under a "cutoff" method.

2. Thrift institutions.—Thrift institutions that use the reserve method to compute their deductions for losses on bad debts may do so using either the experience method allowed to small banks or the percentage of taxable income method with the percentage reduced to 5 percent from 40 percent as under present law. In order to be eligible for the special treatment of bad debt reserves, at least 60 percent of the assets of the financial institution must be invested in qualifying assets.

The excess of the bad debt deduction of thrift institutions computed under the percentage of taxable income method over the deduction computed under the experience method is treated as a tax preference for alternative minimum tax purposes. The excess will not, however, constitute a preference item for purposes of the 20% reduction of present law for corporate tax preferences.

Effective date.—These provisions apply to taxable years beginning on or after January 1, 1986.

B. Interest on Debt to Purchase or Carry Tax-exempt Bonds

The bill disallows 100 percent (as opposed to 20 percent under present law) of deductions for interest expense allocable to tax-exempt obligations acquired after December 31, 1985. The 20-percent disallowance rule of present law continues to apply with respect to tax-exempt obligations acquired from 1983 to 1985. Transitional rules are provided for obligations acquired pursuant to a written commitment to purchase entered into before September 25, 1985 and for certain general purpose governmental bonds issued by a governmental unit in 1986, 1987, and 1988 in amounts not exceeding $10 million a year.

C. Special Rules for Net Operating Loss Carryovers of Depository Institutions

The provision of present law allowing a carryback period of 10 years and a carryforward period of 5 years for the net operating losses of depository institutions is repealed effective for losses incurred in taxable yers beginning after December 31, 1985. Losses incurred in taxable years beginning after 1985 are required to be carried back 3 years and carried forward 15 years in accordance with the general rules for net operating losses.

D. Repeal of Special Rules for Reorganizations of Financially Troubled Thrift Institutions

The bill repeals rules enacted in 1981 that provide special relief to financially troubled thrift institutions. These rules, which were designed to facilitate tax-free mergers of thrift institutions, provide that the continuity of interest requirement is met if the depositors of a financially troubled thrift are depositors of the surviving corporation; allow the carryover of net operating losses of a financially troubled thrift where its depositors continue as depositors of the acquiring corporation; and exempt certain payments from the Federal Savings and Loan Insurance Corporation to financially troubled thrift institutions from income and the general basis reduction requirements of the Code.

The repeal of the rules providing relief under the reorganization and net operating loss carryover provisions is effective for acquisitions or mergers occurring after December 31, 1985. The repeal of the exclusion for certain FSLIC payments is effective for payments received in taxable years beginning on or after January 1, 1986, except for payments made pursuant to an agreement entered into before that date.

E. Depositor Deductions in Cases of Troubled Financial Institutions

Individuals are given an election to deduct losses on deposits in qualified financial institutions as a casualty loss at the time the loss can be reasonably estimated. The election applies only where the loss arises as a result of the bankruptcy or insolvency of the financial institution and is not available to any one-percent shareholder, officer, or relative or related party of a one-percent shareholder or officer of the institution. The provision is effective for losses incurred in taxable years beginning after December 31, 1982.

Title IX. Accounting Provisions

A. General Provisions

1. Simplified dollar-value LIFO method for certain small businesses

The bill provides an election to use a simplified method of computing LIFO inventory values for taxpayers with average annual gross receipts of $5 million or less, effective for taxable years beginning after December 31, 1985. The method uses inventory pools established in accordance with general categories of inventory items published by the Bureau of Labor Statistics.

2. Limitations on the use of the cash method of accounting

The bill prohibits, with certain exceptions, the use of the cash method of accounting to any C corporation, partnership that has a C corporation as a partner, or tax-exempt trust with unrelated business income. Excepted entities, that can continue to use the cash method, are farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less. In the case of services, the time of accrual of income by the provider and deduction by the recipient generally is the time of billing. The provision is effective for taxable years beginning after December 31, 1985.

3. Pledges of installment obligations

The bill provides that the proceeds of a loan for which an installment obligation is pledged as collateral generally is treated as a payment on the obligation, resulting in the recognition of a proportionate part of the deferred gain. Exceptions are provided for the pledge of all of the assets of an active trade or business pursuant to a general lien in favor of a financial institution and for certain other situations. The provisions of the bill apply to pledges after December 31, 1985, and pledges before that date of installment obligations arising after September 25, 1985. Certain transitional rules are provided.

4. Accounting for production costs and long-term contracts

a. Uniform capitalization rules.—The bill provides that, in general, uniform rules for determining costs that must be capitalized apply to all producers of tangible property, including inventory, noninventory property held for sale to customers, and assets constructed for self-use. These comprehensive capitalization rules are based on the rules of present law applicable to extended period long-term contracts. The rules generally are effective for costs paid or incurred after December 31, 1985. In the case of inventories, the rules apply to the taxpayer's first taxable year beginning after December 31, 1985.

b. Interest.—Interest is subject to a special rule requiring capitalization only if the property is long-lived or requires more than two years (one year if the cost of the item is greater than $1 million) to produce. This rule applies to interest incurred after December 31, 1985.

c. Farming and ranching costs.—The uniform capitalization rules generally apply to costs (including interest) incurred in producing crops and livestock (other than animals held for slaughter) having a preproductive period of more than two years. An exception is provided for certain farmers, who may elect to expense preproductive period costs. Electing taxpayers must use nonincentive depreciation for all farm property, and the deducted amounts are recaptured (i.e., gain will be ordinary to the extent of the deductions) upon disposition of the property. The provision is effective for costs paid or incurred after December 31, 1985.

d. Long-term contracts.—The completed contract method of accounting is repealed except for certain contracts involving real estate construction. Contracts taking more than one year to complete must be reported on the percentage of completion method. Interest must be paid by (or to) the taxpayer if the reported profit on a contract each year is more (or less) than a portion of the actual profit on that contract allocable to that year. This provision is effective for long-term contracts entered into after December 31, 1985.

e. Timber.—The uniform capitalization rules generally apply to all costs (including interest) of producing timber. An exception is provided for certain small timber producers, who may elect to amortize costs otherwise subject to capitalization over a period of five years. An electing producer must use nonincentive depreciation for all assets used in the timber business. This provision is effective for production costs, including interest, incurred after December 31, 1985, except that costs attributable to timber planted before January 1, 1986, are subject to a special five year phase-in.

5. Reserves for bad debts

The bill generally repeals the reserve method of computing deductions for bad debts. Under the bill, taxpayers, other than certain financial institutions, are allowed a deduction for bad debts when the debt becomes wholly or partially worthless. Wholly worthless debts must be treated as worthless on a taxpayer's books in order to be allowed as a deduction for Federal income tax purposes, as is the case under present law for partially worthless debts. The balance of any reserve for bad debts or guarantees is taken into income ratably over a period of five years. The provision is effective for taxable years beginning after December 31, 1985.

6. Accrued vacation pay

The bill limits the deduction for additions to a reserve for vacation pay to amounts that are paid within the taxable year and eight and one-half months after the close of the taxable year. The provision is effective for taxable years beginning after December 31, 1985.

7. Contributions in aid of construction

The bill provides that utilities must include in gross income the value of any property, including money, that it receives to encourage it to provide services to, or for the benefit of, the person transferring the property. The provision of present law that allows certain utilities to treat these amounts as contributions to capital is repealed effective for taxable years beginning after December 31, 1985.

B. Timber Provisions

1. Capital gains treatment for timber

The bill provides that, in the case of dispositions after December 31, 1988, capital gains treatment is available only for natural persons, estates, and trusts, all of the beneficiaries of which are natural persons or estates. A modified corporate alternative capital gains rate is provided for dispositions of timber by corporate taxpayers prior to that date. Dispositions of timber grown on Federal lands do not qualify for capital gains treatment after December 31, 1985.

2. Reforestation expenditures

The bill repeals the provisions of present law allowing an election for 7-year amortization and an investment tax credit with regard to certain reforestation expenditures, effective for expenditures made after December 31, 1985.

C. Provisions Relating To Agriculture

1. Special expensing and amortization provisions affecting agriculture

The bill amends the provision allowing current deductions for certain soil and water conservation expenditures to limit current deductions to costs of improvements consistent with a soil or water conservation plan adopted by the U.S. Department of Agriculture, or in the absence of such, by a comparable State agency. The bill also repeals the provisions permitting current deductions for land clearing expenses and for certain soil conditioning activities. These provisions apply to expenditures incurred after December 31, 1985.

2. Dispositions of converted wetlands and erodible croplands

The bill provides that gain from the disposition of highly erodible land that is converted to agricultural use (other than livestock grazing) is not eligible for capital gain treatment, effective for dispositions after December 31, 1985.

3. Netting for cooperatives

Cooperatives (including tax-exempt farmers' cooperatives) are permitted to offset patronage earnings and losses in computing net earnings for the purpose of paying patronage dividends. Cooperatives that do so are required to notify affected members. The provision relating to netting is effective for taxable years beginning after December 31, 1962. The provision relating to the notice re-

quirement is effective for taxable years beginning after the date of enactment of the bill.

4. Treatment of certain plant variety protection certificates as patents

The bill provides that plant protection certificates issued under the Plant Variety Protection Act of 1970 are treated as patents for determining the character of gain on their disposition, effective for dispositions after December 31, 1985.

Title X. Insurance Products and Companies

A. Insurance Policyholders

1. Interest on installment payments of life insurance proceeds.—The bill repeals the provision of present law under which the income on the proceeds of life insurance that are paid to a surviving spouse in periodic payments are includible in gross income only to the extent that the amount of income paid during any taxable year exceeds $1,000. The provision is effective for amounts received with respect to deaths occurring after December 31, 1985.

2. Deduction for nonbusiness casualty losses.—Under the bill, in the case of a loss covered (wholly or partially) by insurance, a taxpayer is permitted to deduct a casualty loss for damages to property not used in a trade or business or in a transaction entered into for profit only to the extent of losses not covered by insurance and only if the taxpayer files a timely insurance claim with respect to damage to that property. The provision applies to losses sustained in taxable years beginning after December 31, 1985.

3. Exclusion from income for structured settlements limited to cases involving physical injury.—The bill limits the exclusion from income for qualified assigments under structured settlement agreements to those assignments requiring the payment of damages on account of a claim for personal injuries or sickness involving physical injury or sickness (including death). The provision is effective for assignments entered into after December 31, 1985.

B. Life Insurance Companies

1. Special life insurance company deduction.—Under the bill, the special life insurance company deduction equal to 20 percent of tentative life insurance company taxable income (LICTI) is repealed, effective for taxable years beginning after December 31, 1985.

2. Status for certain organizations providing commercial-type insurance.—The bill provides, for taxable years beginning after December 31, 1985, that certain organizations (described in sec. 501(c)(3) or (4)) are entitled to tax exemption only if no substantial part of their activities is providing commercial-type insurance (including the issuance of annuity contracts). In addition, the commercial-type insurance activities of an otherwise tax-exempt organization are treated as an unrelated trade or business which is subject to tax under Subchapter L.

Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients, incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations, or property and casualty insurance (such as fire insurance) provided

directly or through a wholly-owned corporation by a church or convention or association of churches.

In the case of Blue Cross and Blue Shield organizations, the bill authorizes the issuance of regulations to provide special treatment in the case of insurance provided to high risk individuals and small groups. This special treatment is not available to the extent that applicable State law requires the provision of insurance to such individuals or groups.

Further, the bill requires the Department of the Treasury to conduct a study of fraternal beneficiary associations (sec. 501(c)(8)) that received gross annual insurance premiums in excess of $25 million in 1984.

Transition rules are provided for certain organizations with respect to their pension businesses.

3. Operations loss deduction of insolvent companies.—The bill permits a life insurance company to apply unused net operating loss carryovers against the increase in its taxable income attributable to the amount deemed to be distributed from its policyholders surplus account. This provision only applies if (1) the company was insolvent on November 15, 1985, (2) the company is liquidated pursuant to a court order, and (3) as a result of the liquidation, the company's tax liability would be increased by policyholder surplus account distributions. This provision is effective for liquidations occurring after on or November 15, 1985.

C. Property and Casualty Insurance Companies

1. Inclusion in income of 20 percent of unearned premium reserve.—Under the bill, a property and casualty insurance company is required to reduce its deduction for unearned premium reserves by twenty percent. This provision is phased in over a five year period commencing with taxable years beginning after December 31, 1985. For the five taxable years beginning after that date, a total of 20 percent (4 percent each year) of a company's unearned premium reserve for its most recent taxable year beginning before January 1, 1986, is included in income. For all taxable years beginning after December 31, 1985, a company also takes into account only 80 percent of the difference in the reserve for unearned premiums at the end of the preceding year and at the end of the current year.

2. Treatment of certain dividends and tax-exempt interest.—For taxable years beginning after December 31, 1985, a property and casualty insurance company's deduction for losses incurred is reduced by a portion of the company's tax-exempt income and the deductible portion of dividends received (with special rules for dividends from affiliates). The portion taken into account is 10 percent of tax-exempt income and the deductible portion of dividends received from investments made after November 14, 1985 (increasing to 15 percent in taxable years beginning after December 31, 1987).

3. Taxable income must bear certain relationship to net gain from operation.—For taxable years beginning after December 31, 1987, the regular taxable income of a property and casualty insurance company shall not be less than 20/36 of its adjusted net gain from operations, and its regular taxable loss shall not be greater than 20/36 of its adjusted net loss from operations. Adjusted net gain or

loss from operations means the net gain or loss from operations required to be set forth on the company's annual statement approved by the National Association of Insurance Commissioners, determined with regard to policyholder dividends but without regard to Federal and foreign income taxes, adjusted to exclude certain tax-exempt income and the deductible portion of certain dividends received attributable to investments made before November 15, 1985.

4. Study of treatment of loss reserves.—The Treasury Department is required to conduct a study of the tax treatment of loss reserves of property and casualty insurance companies, to be submitted no later than January 1, 1987.

5. Repeal of protection against loss account.—Effective for taxable years beginning after December 31, 1985, the deduction for contributions to the protection against loss account for mutual property and casualty companies is repealed. Balances in the account are includable in income no less rapidly than ratably over the first five years beginning after December 31, 1985, or, if more rapidly as such amounts would have been included over the five years had the PAL account provision not been repealed.

6. Revision of special treatment for small companies.—Under the bill, property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) which do not exceed $500,000 for the taxable year are exempt from tax. Property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) that exceed $500,000 but do not exceed $2,000,000 may elect to be taxed only on taxable investment income. In the case of a controlled group, these amounts are determined on a group basis. The provisions are effective for taxable years beginning after December 31, 1985.

7. Study of treatment of policyholder dividends by mutual property and casualty insurance companies.—Under the bill, the Treasury Department is required to conduct a study of the treatment of policyholder dividends of mutual property and casualty insurance companies, to be submitted no later than January 1, 1987.

Title XI. Pensions and Deferred Compensation; Fringe Benefits; ESOPs

Pension and Deferred Compensation Provisions

A. *Limitations on Tax-Deferred Savings*

1. Individual retirement accounts.—The bill provides that an individual's IRA deduction limit is reduced, dollar for dollar, by the amount of the individual's elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity.

In addition, the bill provides special rules to ensure that electing spouses with some earned income are not precluded from receiving spousal IRA contributions.

2. Qualified cash or deferred arrangements

a. *Limit on elective deferrals.*—The bill limits the annual elective deferrals made by or on behalf of any employee under all qualified cash or deferred arrangements and tax-sheltered annuities to $7,000 and coordinates that limit with the IRA deduction limit.

b. *Nondiscrimination rules.*—In addition, the bill modifies the special nondiscrimination tests by redefining the group of highly compensated employees and modifying the percentage tests. Under the bill, the actual deferral percentage for an employer's highly compensated employees may not exceed 125 percent of the actual deferral percentage of eligible nonhighly compensated employees. Alternatively, the deferral percentage of an employer's highly compensated employees could not exceed the lesser of 200 percent of the actual deferral percentage of the nonhighly compensated employees, or the actual deferral percentage of the nonhighly compensated employees plus two percentage points.

The bill generally provides that an employee will be treated as highly compensated for a plan year if, during the current plan year, or either of the two preceding plan years he or she was:

(1) a five-percent owner of the employer;

(2) an employee earning more than $50,000; or

(3) one of the top 10 percent of employees by pay, excluding (i) employees who earn less than $20,000, and (ii) employees who earn less than $35,000 and are not among the top five percent by compensation.

The bill provides special rules for determining those employees who are to be considered highly compensated in the current plan year because they have more than $50,000 of compensation, or are in the top 10 percent of employees by compensation. A special rule also is provided for family members of five-percent owners and the top 10 employees by compensation.

c. *Withdrawal and other restrictions.*—The bill also (1) permits a qualified cash or deferred arrangement to make total distributions upon plan termination, (2) limits amounts that may be withdrawn

on account of hardship to the total amounts of elective deferrals; (3) precludes a qualified cash or deferred arrangement from requiring, as a condition of eligibility, that an employee complete more than one year of service; (4) provides that no employer may (a) condition, directly or indirectly, contributions under any plan upon the employee's elective deferrals, or (b) take elective deferrals under a qualified cash or deferred arrangement into account in determining whether any other plan satisfies the general coverage or nondiscrimination rules; (5) imposes an excise tax on excess contributions to a qualified cash or deferred arrangement if the excess is not distributed in a timely manner; and (6) permits employer contributions that satisfy the vesting and distribution restrictions applicable to elective deferrals to be made whether or not the employer has current or accumulated profits.

d. *Employees of tax-exempt and public employers.*—The bill makes it clear that tax-exempt and public employers may not maintain qualified cash or deferred arrangements. However, the bill grandfathers any such plan that had been adopted before November 6, 1985, provided the sponsoring employer had requested a favorable determination letter before that date. Elective deferrals under grandfathered plans are coordinated with elective deferrals under 403(b) tax-sheltered annuities and section 457 plans.

3. Employer matching contributions and employee contributions.—The bill provides that employee contributions and qualifying employer matching contributions, as a percentage of compensation for highly compensated employees, may not exceed 125 percent of the average of such contributions as a percent of compensation for the nonhighly compensated employees. Alternatively, the average percentage for the highly compensated employees may not exceed 200 percent of the average percentage for the nonhighly compensated employees, or the average percentage for the nonhighly compensated employees plus two percentage points, if less.

The average of nonqualifying employer matching contributions as a percent of compensation for the employer's highly compensated employees may not exceed 110 percent of the average of nonqualifying employer contributions as a percent of compensation for the nonhighly compensated employees. Alternatively, the average percentage for the highly compensated employees may not exceed the lesser of 150 percent of the average percentage of the nonhighly noncompensated employees, or the average percentage of the nonhighly compensated employees plus one percentage point.

Excess contributions generally are subject to a 10-percent excise tax, unless the excess, plus earnings, are distributed (or, if nonvested, forfeited) in a timely manner.

4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers.—The bill applies the rules governing eligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans for employees of tax-exempt employers.

In addition, the bill modifies the distribution requirements applicable to pre-death and post-death distributions from an eligible deferred compensation plan. Under the bill, distributions commencing during a participant's lifetime must satisfy a payout schedule under which benefits projected to be paid to the participant during

life are at least two-thirds of the total benefits payable with respect to the participant. If the entire interest has not been distributed before the participant's death, the remainder must be distributed no more slowly than under the lifetime schedule in effect on the date of death. Distributions commencing after death generally must commence within a year of death and be paid over a period not to exceed 15 years, or over the life expectancy of a surviving spouse who is a beneficiary. If any benefits are payable over a period longer than one year, they must be paid on a substantially nonincreasing basis, not less frequently than annually.

5. *Deferred annuity contracts.*—Effective for amounts invested in deferred annuity contracts after September 25, 1985, the bill provides that a nonindividual owner of a deferred annuity contract must include in income any increase in the cash surrender value of the deferred annuity contract over the contract's basis during the taxable year. The owner of a deferred variable annuity contract is treated as owning a pro rata share of the assets and income of any separate account underlying the variable contract. As a result, the owner is not taxed on the unrealized appreciation of assets underlying a variable contract.

The bill also conforms the additional income tax on amounts withdrawn from deferred annuity contracts before age 59-1/2 to the 15-percent tax on early withdrawals from IRAs and other tax-favored retirement arrangements.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990. In addition, a special effective date is provided for certain plans maintained by state and local governments.

B. *Nondiscrimination Requirements*

1. Coverage and nondiscrimination requirements for qualified plans and tax-sheltered annuities

a. *Qualified plans.*—The bill requires the Secretary of the Treasury to conduct a study of the effect of the present-law coverage tests, and to make recommendations on the manner in which the coverage rules might be changed. The study and recommendations must be submitted to Congress no later than July 1, 1986.

b. *Tax-sheltered annuities.*—Generally effective for years beginning after December 31, 1985 (November 21, 1987, in the case of certain programs maintained by State and local governments), the bill extends certain nondiscrimination rules to tax-sheltered annuity programs other than those maintained by churches. With respect to employer (i.e., nonelective) contributions to tax-sheltered annuity programs, the bill applies the general coverage and nondiscrimination tests of present law applicable to qualified pension plans, taking into account the special circumstances of tax-exempt organizations (including the compressed salary ranges of employees).

With respect to elective contributions to tax-sheltered annuity programs (other than programs maintained by churches), the bill

requires that any entity offering the opportunity to make elective deferrals available to any employee must make the election to all employees without a minimum contribution requirement.

2. Certain social security benefits earned with prior employers.—The bill revises the manner in which a pension plan may be integrated with social security, effectively precluding an employer from taking into account benefits attributable to OASDI contributions of former employers of an employee. Pursuant to regulations to be issued by the Secretary of the Treasury, the maximum amount of social security benefits that may be taken into account by any employer may not exceed 1/40 of the total social security benefits permitted to be taken into account multiplied by the number of years of service with that employer.

3. Top-heavy plans.—The bill provides that a uniform benefit accrual rule must be applied in testing whether a defined benefit plan is top heavy. Solely for the purpose of determining whether a plan is top heavy or super top heavy, benefits will be considered to accrue no more rapidly than permitted under the fractional benefit accrual rule.

4. Modification of rules for benefit forfeitures effective for years beginning after December 31, 1985.—The bill creates uniform rules for forfeitures under any defined contribution plan. The bill permits, but does not require, forfeitures to be reallocated to other participants in a money purchase pension plan.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990.

C. Withdrawal of Benefits

1. Uniform minimum distribution rules.—The bill establishes a uniform commencement date for benefits under all qualified plans, IRAs, tax-sheltered annuities and custodial accounts. Under the bill, distributions under a qualified retirement plan must commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70-1/2, without regard to the actual date of retirement.

In addition, the bill establishes a new sanction in the form of an excise tax for failure to satisfy the minimum distribution rules.

2. Withdrawal restrictions.—The bill provides that no withdrawals may be made under any tax-sheltered annuity prior to the time an employee attains age 59-1/2, dies, becomes disabled, or separates from service. However, the bill does permit hardship withdrawals of elective contributions.

3. Additional income tax on early withdrawals.—The bill applies a 15-percent additional income tax to withdrawals from a qualified plan, qualified annuity, tax-sheltered annuity, or IRA, made before death, disability, or attainment of age 59-1/2. An exception to this rule is provided for any distribution that is part of a scheduled series of level payments under an annuity for the life of the participant (or the joint lives of the owner and the owner's beneficiary).

A transitional rule makes this tax inapplicable to distributions made to certain participants whose benefits were in pay status on November 6, 1985.

4. Taxation of distributions.—The bill (a) repeals the rule that owners of tax-sheltered annuities are subject to tax when amounts under the annuities become available, (b) repeals the present-law pre-1974 capital gains provisions; (c) replaces the present-law 10-year forward averaging with a new provision permitting one election after age 59-1/2 to claim five-year forward averaging, (d) reorders the present-law basis recovery rules for amounts withdrawn prior to a participant's annuity starting date; (e) eliminates the special three-year basis recovery rule of present law effective for participants whose annuity starting date is after July 1, 1986; and (f) modifies the general basis recovery rules for amounts paid as an annuity.

Special transition rules applicable to individuals who will have attained age 50 on or before January 1, 1986, (1) permit such individuals to make one additional election to claim five-year forward averaging treatment before attainment of age 59-1/2 and (2), solely with respect to such individuals, separately phase out over six years the pre-1974 capital gains provisions.

5. Loans.—Generally effective for loans made after December 31, 1985, the bill (a) reduces the present-law $50,000 limit on loans not treated as distributions by the highest outstanding loan balance of the prior 12 months; (b) provides an exception to the five-year repayment rule only for loans applied to the purchase of the participant's principal residence; and (c) requires level amortization of a loan over the permissible repayment period.

In addition, also effective for loans made after December 31, 1985, the bill provides a deferral of the deduction for interest paid by employees on loans secured by elective deferrals from a 401(k) plan or tax-sheltered annuity (403(b) plan), and also by key employees on loans from any qualified plan. Under the bill, the deferral would be accomplished by denying a deduction for interest, and increasing the participant's basis under the plan by the amount of nondeductible interest paid.

Except as otherwise noted, these provisions apply for years beginning after December 31, 1985.

D. Limits on Tax Deferral

1. Adjustments to limitations on contributions and benefits under qualified plans.—The bill makes several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on annual additions under defined contribution plans is decreased from $30,000 to the greater of $25,000, or 25 percent of the defined benefit plan dollar limit. In applying this limit, the bill provides that all employee contributions are treated as annual additions.

The bill also reduces the dollar limit on the annual benefit payable under defined benefit plans from $90,000 to $77,000. If the retirement benefit under a defined benefit plan begins before age 62, the $77,000 limitation generally is reduced so that it is the actuarial equivalent of an annual benefit of $77,000 beginning at age 62.

Special rules are provided for commercial airline pilots, police and firefighters under transitional rules provided by the bill, benefits already accrued by a plan participant under an existing plan are not affected by the reductions.

In addition, the bill (1) permits contributions to a qualified cost-of-living arrangement, (2) provides a limit on compensation that may be taken into account under any qualified plan (an amount equal to seven times the defined contribution plan limit), and (3) adds a new 15-percent excise tax on certain excess retirement distributions.

2. Limits on employer deductions.—The bill makes several changes to the limits on employer deductions for contributions to qualified plans. The bill (1) repeals the limit carryforward applicable to profit-sharing and stock bonus plans; (2) extends the combined plan deduction limit to any combination of a defined benefit pension plan and a money purchase pension plan; (3) requires that certain social security taxes be taken into account in applying the 15 percent and 25 percent of compensation deduction limits; and (4) imposes a 10-percent excise tax on excess contributions to qualified plans.

3. Excise tax on reversion of qualified plan assets.—The bill imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the person who receives the reversion. Under the bill, the tax applies to amounts received as a reversion pursuant to the termination of a plan occurring after December 31, 1985.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990.

E. Miscellaneous Provisions Affecting Qualified Plans

1. Plan amendments.—Under the bill, the provisions affecting qualified plans generally apply as of the separately stated effective date (generally years beginning after December 31, 1985). However, a plan will not fail to be a qualified plan for any year beginning before January 1, 1988, provided

(a) the plan complies, in operation, with the changes as of the separately stated effective date;

(b) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1987; and

(c) the amendment applies retroactively to the first day of the first plan year beginning on the separately stated effective date.

Special rules are provided for collectively bargained plans.

2. Penalty for overstatement of pension liabilities.—Effective for returns filed after December 31, 1985, the bill provides a new penalty in the form of a graduated addition to tax applicable to certain income tax overstatements of deductions for pension liabilities. As an addition to tax, this penalty will be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to

the extent of any income tax underpayment that is attributable to such an overstatement. The penalty is similar to the present-law penalty for overvaluations of liabilities.

F. Fringe Benefits

1. Nondiscrimination rules for statutory fringe benefit plans.—Generally effective for years beginning after December 31, 1985, the bill establishes comprehensive nondiscrimination rules as to coverage and benefits for statutory fringe benefit plans. Statutory fringe benefit plans include employer-maintained group-term life insurance plans, health benefit plans (whether self-insured or funded through an insurance company), qualified group legal services plans, educational assistance programs, and dependent care assistance programs. In the case of accident or health plans, the provisions apply for years beginning after December 31, 1986.

2. Nondiscrimination rules for welfare benefit funds and cafeteria plans.—Generally effective December 31, 1985, the bill extends to welfare benefit plans and cafeteria plans nondiscrimination rules similar to those applicable to statutory fringe benefit plans. The bill also modifies the rules governing the year in which benefits under a discriminatory cafeteria plan must be included in income by highly compensated and key employees.

3. Study.—The bill requires that Treasury conduct a study of abuses of the health insurance provisions and make recommendations for changes in the nondiscrimination rules. No later than July 1, 1986, Treasury is required to report the results of the study, together with any recommendations it deems advisable, to the Committee on Ways and Means, the Committee on Finance and the Joint Committee on Taxation.

4. Reporting requirements.—Generally effective for years beginning after December 31, 1985, the bill imposes new reporting requirements with respect to certain fringe benefits paid as wages.

5. Exclusions for 2-year extension of educational assistance and group legal service benefits.—The bill extends for two years the present law exclusions from income for benefits provided under certain employer-maintained educational assistance programs and group legal service plans. The exclusions were scheduled to expire for taxable years beginning after December 31, 1985. Under the bill, exclusions expire for taxable years beginning after December 31, 1987.

G. Changes Relating to Employee Stock Ownership Plans

1. Repeal of employee stock ownership credit.—The bill repeals the special ESOP tax credit for years after 1985. Thus, under the bill, no tax credit is provided for compensation paid or accrued after December 31, 1985.

In addition, effective for terminations after December 31, 1984, the bill amends the tax credit ESOP distribution provisions to permit total distributions upon plan termination.

2. Termination of certain additional tax benefits.—Generally effective for taxable years beginning after December 31, 1988, the bill repeals (a) the special deduction for dividends paid on employer securities allocated to participants' accounts under an ESOP; (b) the provision permitting deferred recognition of gain on certain sales

to an ESOP or eligible worker-owned cooperative, and (c) the provision permitting an ESOP or eligible worker-owned cooperative to assume estate tax liability.

In addition, effective for loans made after December 31, 1988, the bill repeals the 50-percent interest exclusion for interest earned in certain securities acquisition loans.

3. Changes in qualification requirements.—Under the bill, additional qualification requirements are provided for ESOPs. These additional qualification requirements (a) require more rapid (ten-year graded) vesting; (b) modify the ESOP nondiscrimination rules to limit the annual amount of employer contributions that may be allocated to employees who are officers, shareholders, or highly compensated; (c) expand the pass-through voting requirements applicable to employer securities held by an ESOP; (d) permit an eligible plan participant to direct the ESOP trustee to diversify a portion of the participant's ESOP account balance; and (e) modify the distribution and put option requirements, including the timing of the employer's payment of the put option price.

These provisions generally apply to ESOPs adopted after December 31, 1985 and, for ESOPs in existence on that date, to amounts contributed after that date.

Title XII. Unearned Income of Minor Children; Trusts and Estates; Generation-Skipping Transfers

A. Unearned Income of Certain Children

The bill provides special rules for calculating the tax liability of children who are under 14 years of age and whose parent or parents are still alive. The bill taxes the unearned income of a child derived from property transferred from the parents (parental-source unearned income) in excess of the child's personal exemption at the parents' marginal tax rate. Earned income and unearned income that is not parental source unearned income is taxed to the child at the child's marginal tax rate. Unearned income is not treated as parental source unearned income if the income is derived from a qualified segregated asset. A qualified segregated asset generally includes earned income, money, or property received from someone other than a parent, and property received by reason of the death of a parent. These provisions are effective for taxable years beginning after December 31, 1985.

B. Income Taxation of Trusts and Estates

Under the bill, the income of most non-grantor trusts is taxed during the lifetime of the grantor at the marginal tax rate of the grantor without a deduction for distributions to beneficiaries. After the death of the grantor, the income of all trusts created by the grantor and the grantor's estate is taxed without a distribution deduction and by allocating one set of tax brackets among the grantor's estate and all trusts created by the grantor.

If one beneficiary is entitled to all distributions from a trust and all undistributed amounts are ultimately subject to the control of the beneficiary (called a "qualified beneficiary trust"), the income of that trust is taxed at the marginal tax rate of the beneficiary.

If all beneficiaries of the trust are children of a grantor (called a "qualified children's trust"), the income of the trust may be taxed at the marginal rate of any child for any year that the child is minor.

A grantor of a trust is treated as the owner of the trust if the grantor retains a power to revoke the trust, if the grantor (or grantor's spouse) retains the right to receive the trust income or the power to use the trust income, and if the grantor retains certain administrative powers over the trust.

The provisions of the bill are effective for trusts created, and trust contributions made, on or after September 25, 1985. In the case of estates, the provisions are effective for decedents dying on or after September 25, 1985.

C. Generation-skipping Transfer Tax

The bill amends the present generation-skipping transfer tax to impose a flat-rate tax both on transfers involving a sharing in benefits in more than one generation and direct transfers that skip generations. A $1 million per transferor specific exemption is provided, with transfers in excess of that amount being subject to tax at a rate equal to the maximum gift and estate tax rate.

Title XIII. Compliance and Tax Administration

A. *Penalties*

1. Penalty for failure to file information returns or statements.—The bill consolidates the present-law penalty for failure to file an information return with the IRS and the present-law penalty for failure to supply a copy of the information return to the taxpayer. The bill also provides a new penalty for failure to include correct information on an information return. This applies to information returns the due date for which is after December 31, 1985.

2. Increase in penalty for failure to pay tax.—The bill increases the penalty for failure to pay taxes from one-half of one percent under present law to one percent after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. This applies to amounts assessed after December 31, 1985.

3. Negligence and fraud penalties.—The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also provides that failure to report on a tax return any amount reported on an information return is considered negligence in the absence of clear and convincing evidence to the contrary. The bill modifies the fraud penalty by increasing the rate to 75 percent but applying the penalty only to the amount of the underpayment attributable to fraud. This is effective for returns the due date of which is after December 31, 1985.

B. Estimated Tax Payments by Individuals

The bill increases from 80 to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty, effective for taxable years beginning after December 31, 1985.

C. Attorney's Fees and Exhaustion of Administrative Remedies

1. Attorney's fees.—The bill extends through the end of 1989 the provision of present law authorizing awards of attorney's fees in tax cases where the Government's position was unreasonable. The bill also provides that all or a portion of that award may be assessed against an IRS employee if the court determines that that employee's arbitrary or capricious act caused the lawsuit to occur. This applies generally to proceedings commenced after December 31, 1985.

2. Exhaustion of administrative remedies.—If a taxpayer does not use reasonable efforts in good faith to resolve a dispute through administrative proceedings (such as, for example, meeting with the Appeals Division of the IRS), the Tax Court may award damages of $120 to the United States. This applies to any action or proceeding in the Tax Court commenced after December 31, 1986.

D. Tax Administration Provisions

1. Authority to rescind notice of deficiency.—The bill gives the IRS authority, if the taxpayer consents, to rescind a statutory notice of deficiency.

2. Authority to abate interest.—The bill gives the IRS the authority to abate interest attributable to error or delay by an IRS employee in performing a ministerial act.

3. Suspension of compounding when underlying interest is suspended.—The bill suspends the compounding of interest in circumstances in which the underlying interest on the deficiency is also suspended.

4. Additional exemption from levy.—The bill exempts from IRS levy military service disability benefits.

5. Modification of amounts subject to administrative forfeiture.—The bill increases the value of property subject to administrative forfeiture because it has been used in violating Internal Revenue laws to the level applicable to similar Customs offenses.

6. Certain recordkeeping requirements.—The bill provides that IRS special agents are subject to the same income inclusion and recordkeeping rules that other law enforcement officers are with respect to use of an automobile.

E. Interest Provisions

1. Differential interest rate.—The bill provides that the Government pays interest to taxpayers at the three-month Treasury bill rate plus 2 percentage points, and that taxpayers pay interest to the Government at the three-month Treasury bill rate plus 3 percentage points. These rates are adjusted quarterly, and apply to interest for periods after December 31, 1985.

2. Interest on accumulated earnings tax.—The bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date of the tax return with respect to which that tax is imposed. This applies to returns the due date for which (determined without regard to extensions) is after December 31, 1985.

F. Modification of Withholding Schedules

The bill instructs the Treasury to modify withholding schedules to better approximate actual tax liability under the amendments made by the bill.

G. Information Reporting Provisions

1. Real estate transactions.—The bill provides that the settlement attorney or other stakeholder must provide an information report on real estate transactions. This is effective on January 1, 1986.

2. Information reporting on persons receiving Federal contracts.—The bill requires Federal executive agencies to provide information reports on contracts that they enter. Reporting is required beginning on January 1, 1986.

3. Information reporting on State and local taxes.—The bill (sec. 145) requires that State and local governments provide information reports on income taxes, real property taxes, or personal property taxes they collect, effective with respect to payments received after December 31, 1986.

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4. Tax-exempt interest.—The bill requires every person who files an income tax return to report on that return the amount of tax-exempt interest received or accrued during the taxable year. This applies to taxable years beginning after December 31, 1985.

H. Report on Return-Free System

The bill requires the Treasury to report to Congress on the potential for implementing a return-free system for individuals. The report is due not later than six months after the bill's enactment.

I. Collection of Diesel Fuel Excise Tax

The bill provides that the diesel fuel excise tax may be imposed on the wholesaler (rather than the retailer) of the fuel. This applies to sales after the first calendar quarter beginning more than 60 days after the date of enactment.

Title XIV. Miscellaneous Provisions

1. Foster Care Payments

Currently, a foster parent may exclude from gross income reimbursements for expenses of caring for a foster child. The bill modifies the exclusion to apply to foster care payments, rather than expense reimbursements, so that detailed recordkeeping by the foster parents will not be necessary. This provision is effective for tax years beginning after December 31, 1985.

2. Reinstatement of Rules for Spouses of Vietnam MIA's

Under the bill, certain tax relief provisions applicable with respect to Vietnam MIA's (and their spouses) that expired after 1982 are retroactively reinstated and made permanent.

3. Olympic Trust Fund and Excise Tax on U.S. Television and Radio Olympic Broadcast Rights

a. Excise tax.—The bill imposes a new 10-percent excise tax on amounts paid for U.S. television and radio Olympic broadcast rights, effective for amounts paid after November 22, 1985, for such rights other than pursuant to binding contracts in effect on November 22, 1985. The excise tax is to apply notwithstanding any U.S. treaty provision entered into before, on, or after the date of enactment.

b. Olympic Trust Fund.—The bill establishes a new United States Olympic Trust Fund, to receive amounts from the new excise tax. Trust Fund monies are to be available, less related Treasury administrative expenses, to be paid to the U.S. Olympic Committee for training facilities, coaches, and other Olympic-related development expenditure purposes.

4. Exemption From UBIT for Certain Activities

The bill provides exemptions from the unrelated business income tax (UBIT), in the case of certain tax-exempt organizations eligible to receive charitable contributions, for income from (a) exchanges or rentals of mailing lists with or to other such organizations, and (b) certain distributions of low cost articles incidental to soliciting charitable contributions, effective on the date of enactment.

5. Allocation of Cooperative Housing Corporations

Cooperative housing corporations that charge tenant-stockholders with a portion of the cooperative's interest and taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes allocable to each tenant-stockholder's dwelling unit, may elect to have such tenant-stockholders deduct the separately allocated amounts for income tax purposes (rather than amounts based on proportionate ownership of the shares of the co-

operative). The provision is effective for taxable years beginning after December 31, 1985.

6. Personal Holding Companies

An exception from the definition of personal holding company income is provided for computer software royalties that are received by certain corporations that are actively engaged in the business of developing computer software. Another exception is provided from the definition of personal holding company income for interest on securities held in the inventory of a dealer in securities. In addition, a dealer in securities may deduct interest on "offsetting loans" in computing its interest income. The provisions are effective for royalties and interest received after December 31, 1985.

7. Adoption Assistance Program of the Social Security Act

The bill modifies the Adoption Assistance Program under Title IV-E of the Social Security Act to provide assistance for certain expenses incurred in adopting a child with special needs. These are the same expenses as qualify for the present-law itemized deduction which is repealed in Title I of the bill.

Title XV. Technical Corrections

This title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, the Retirement Equity Act of 1984, and other recently enacted tax legislation, as well as similar amendments to nontax provisions of the Deficit Reduction Act of 1984.

III. GENERAL REASONS FOR THE BILL

Overview

In the last year, the committee has undertaken an extensive examination of the current tax system. Public hearings held by the committee have revealed increasing disrespect for, and dissatisfaction with, the Federal income tax system. Despite the large tax rate reductions enacted in 1981, the tax system is believed to place an overly high burden on many individuals and to distribute this burden unfairly among taxpayers. In the course of the committee hearings, certain abuses and inequities were found in the tax system. The tax code contains a maze of intricate provisions that allow financially sophisticated individuals and corporations to avoid significant tax liability by engaging in elaborate tax-motivated transactions, many of which serve no economic purpose. As a result of these unintended tax benefits, the burden of the income tax has been unfairly shifted to those taxpayers who are unable or unwilling to engage in complex tax avoidance transactions.

The committee has observed that, as narrowly focused incentives proliferate, the income tax loses its ability to collect tax revenues and becomes increasingly intrusive in economic affairs. Erosion of the tax base creates a need for higher marginal tax rates in order to maintain tax revenues. Higher marginal tax rates discourage work effort and discourage saving relative to consumption. Tax incentives, even if individually designed to promote desired objectives, collectively cause significant economic distortions and increase the burden of the tax system in other sectors of the economy. Incentives designed to encourage investment and increase productivity often have unintended results, such as the substitution of less productive, but tax-favored, assets for more productive investments. For example, excessive tax incentives have encouraged the construction of office buildings in communities with already record high office vacancy rates. Tax incentives designed to aid farmers have shifted the ownership of farm property from family farmers to investors with higher marginal rates, since the latter obtain greater benefits from the tax deductions provided. In many cases, such investments are made only because they produce large deductions and credits that may be used to offset other income, and, importantly, not because there is a market demand for the services provided by these investments. Over the history of the Federal income tax, the tax code has become overloaded with provisions that fail to accomplish the objectives for which they were originally intended.

The committee believes the tax system is nearing a crisis point. The committee has grasped an historic opportunity to restore confidence in the tax system and to assure the productive use of our resources. Unless decisive action is taken now, compliance with the

tax system will further erode and the inefficiencies introduced by the tax system will restrict the potential growth of the economy.

To correct the many problems of the present tax system, the committee believes that it is of utmost importance to reduce marginal tax rates. Lower rates reduce the tax burden on many taxpayers, the predominance of tax considerations in business and personal decisions, and the bias in favor of consumption over saving. The goal of lower marginal rates can best be achieved by reducing and eliminating inefficient subsidies and unintended preferences in the Code. By closing loopholes and eliminating abuses, this bill helps ensure that no individual or corporation will excessively transfer tax burdens to other taxpayers by manipulating the tax system. The bill contributes greatly to improving the equity of the tax system and the efficiency of the economy, without altering the total tax revenues collected.

Tax Equity

The committee believes that the tax system should not impose radically different tax burdens on taxpayers with similar abilities to pay. If some individuals and corporations avoid paying their fair share of taxes, other taxpayers will be required to make increased tax payments if total tax revenues are to remain unchanged.

The committee has observed that certain tax provisions allow many corporations to pay relatively little Federal income tax, without stimulating investment and production as intended. While the statutory corporate tax rate is 46 percent, studies have shown that the average tax rate on corporations is far lower. Many firms have made use of tax provisions to reduce their tax liability to zero, and, in some cases, corporations with substantial book income obtain tax refunds.

Between 1950 and 1985, the corporate income tax as a percentage of total budget receipts has declined from 27 percent to only 8 percent. Over the same period, the corporate income tax as a percentage of total income tax receipts has declined from 40 percent to only 16 percent, despite a slower decline in the relative share of income earned by corporations. To restore the traditional balance of the income tax between individuals and corporations, the committee has greatly restricted the ability of corporations to eliminate their tax liability. For example, the committee has adopted a broad-based corporate alternative minimum tax, including a wide range of preference items and applying at a rate of 25 percent. This provision replaces the present add-on minimum tax, which has failed to prevent substantial corporate tax avoidance due to its structural defects and the limited range of preferences to which it applies.

Tax provisions that have been used by various industries to reduce substantially their tax liabilities have been carefully reviewed by the committee, and many such provisions have been eliminated, restricted, or allowed to expire. Under the bill, for example, large commercial banks will no longer be allowed to take deductions for bad debts before the underlying loan is determined to be wholly or partially worthless. Defense contractors and large construction firms will no longer be permitted to defer income to the future, while they take current deductions for expenses. Abuses

of the installment method of accounting will be reduced, and other accounting provisions will be substantially tightened. The taxation of property and casualty insurers is altered to measure income more accurately. Certain charitable and social welfare organizations that engage in insurance activities will not be treated as tax-exempt if a substantial part of their activities is providing commercial-type insurance.

Under the bill, the share of total income tax receipts paid by corporations will increase relative to present law, but will generally remain below pre-1980 levels. The tables below show the historical percentages of total budget and total income tax receipts paid by corporations and the projected percentages under present law and under the bill. As shown, the share of total taxes paid by corporations is estimated to increase by an average of 2.9 percentage points over the next five years. While this increase is significant relative to the present law projections, the estimated share of taxes paid by corporations is still modest in comparison to historical levels. The committee believes the increase in the corporate share of taxes helps correct an unwarranted shift in the tax burden to individuals, while maintaining the necessary incentives for growth in the corporate sector.

CORPORATE INCOME TAX AS A PERCENTAGE OF TOTAL BUDGET RECEIPTS AND TOTAL INCOME TAX RECEIPTS, UNDER PRESENT LAW AND UNDER THE COMMITTEE BILL (BY FISCAL YEAR)

	Percentage of total budget receipts		Percentage of total income tax receipts	
	Present law	Committee bill	Present law	Committee bill
1950	26.5	.....	39.9	.....
1955	27.3	.....	38.3	.....
1960	23.2	.....	34.6	.....
1965	21.8	.....	34.3	.....
1970	17.0	.....	26.6	.....
1975	14.6	.....	24.9	.....
1980	12.5	.....	20.9	.....
1985	8.4	.....	15.6	.....
1986 [1]	9.3	11.2	16.8	20.1
1987 [1]	10.1	12.8	18.0	22.9
1988 [1]	10.0	13.0	17.7	23.2
1989 [1]	9.8	13.0	17.2	22.9
1990 [1]	9.0	12.7	15.8	22.3

[1] Present law percentages for 1986–1990 are based on Congressional Budget Office, August 1985, projections. Committee bill projections are calculated by the Joint Committee on Taxation using the Congressional Budget Office baseline.

The committee also desires to restrict the ability of individual taxpayers to eliminate their tax liabilities through participation in tax shelters. The committee bill provides an expanded alternative minimum tax for individuals. The committee has expanded the

preferences included in this calculation, and has increased the tax rate on this alternative tax base to 25 percent, as with the corporate minimum tax. The alternative minimum tax provided by this bill places a direct limitation on the ability of high-income taxpayers to use tax shelter losses to reduce tax on income from unrelated activities. The committee bill also places limits on the interest deductions provided by tax shelters.

The committee is concerned that, under present law, some taxpayers can exclude or deduct from income certain items that differ little from items that are treated as taxable compensation or nondeductible expenditures for other taxpayers. Fairness requires that these items be treated similarly. Therefore, the committee placed limits on certain business deductions that partially serve personal purposes. Business meal and entertainment expenses are only 80 percent deductible under the bill. The bill retains present law deductions for most business travel expenses, but eliminates certain abuses such as deductions for attending investment seminars and the treatment of certain vacation expenses as charitable deductions. The bill also provides that unemployment benefits may no longer be excluded from income. Additionally, the committee has limited the current exclusions from income for certain scholarships and prizes and awards.

The present tax system provides highly favorable treatment for pensions and certain other deferred compensation plans. Individuals may postpone income tax on current compensation set aside for retirement, and on the investment earnings of those savings, under qualifying plans. The committee has taken steps to ensure that the preferential tax treatment of these plans is limited to encouraging savings for retirement purposes. The committee has increased the tax on preretirement distributions from such funds and limited the ability to borrow from these funds. The committee has also imposed a tax on the reversion of a plan's assets to the employer, in order to prevent employers from exploiting provisions designed solely to encourage retirement savings. The bill imposes stricter limitations on the amount of income that may be contributed to salary reduction (401(k)) plans, and establishes more uniform nondiscrimination rules to prevent the use of such plans only for highly compensated employees. Similarly, the bill imposes nondiscrimination rules as a condition for favorable tax treatment for health insurance benefits, and tightens existing nondiscrimination rules for other benefits to insure that favorable tax treatment for these benefits is available only if the benefits are provided to a substantial portion of the workforce.

The committee also desires to restrict a technique used by some high-income individuals with children to take undue advantage of the graduated rate schedules. Under the bill, unearned income of a child under 14 years old, attributable to property received from the parents, is to be taxed at the top marginal rate of the parents.

The committee believes that another important aspect of fairness is the tax treatment of low-income and middle-income households. The committee has designed the provisions dealing with the personal exemption, standard deduction, and individual tax rates to provide an equitable distribution of tax relief. Under present law, many families below the poverty level pay income taxes. The large

increases in the standard deduction (formerly the zero bracket amount), the personal exemption, and the expansion of the refundable earned income credit, under the committee bill, will raise the tax threshold and ensure that no families below the poverty level will have Federal income tax liability. Under the expanded earned income credit, the maximum credit is $700 and the credit is not totally phased out until an AGI of $16,000. More than 6 million low-income individuals will be removed from the tax rolls as a result of these provisions.

Most elderly and blind taxpayers will also receive a reduction in the taxes they pay under the bill. The increased personal exemption and standard deduction received by all taxpayers, in combination with an extra $600 standard deduction for the elderly and blind, provide tax relief for these individuals. The committee has also retained the present law credit for the elderly and the permanently and totally disabled.

Simplification

The committee believes that, where possible, the tax system should be made more simple. The complexity of the current tax system exacts a cost of time, effort, and burdensome recordkeeping. To some extent, this complexity is necessary to assess accurately one's ability to pay taxes. In addition, some of this complexity is attributable to the increasing complexity of business and financial transactions. For the majority of taxpayers, however, the tax system need not be complex. Perhaps the most important steps taken by the committee bill to reduce the complexity found by many taxpayers are the significant increase in the standard deduction and the imposition of a floor under itemized deductions. Due to these changes, an estimated 13 million taxpayers who presently file itemized returns are expected to file nonitemized returns, which is a 30 percent reduction in the number of itemized returns. These taxpayers will be freed from the need for recordkeeping for many incidental expenditures.

The committee bill eliminates the two-earner deduction and income averaging provisions. Lower marginal rates, in addition to the increases in the standard deduction and personal exemption, reduce the need for these complicated provisions.

The committee bill includes a number of provisions to aid compliance and tax administration. The bill also instructs the Internal Revenue Service to study the feasibility of implementing a return-free system and to report the results to Congress within 6 months.

Economic Efficiency

A major goal of the committee bill is to reduce the interference of the tax system in the efficient allocation of resources in the economy. High marginal tax rates can discourage entrepreneurial initiatives and labor force participation. The bill also is designed to improve the efficiency of the economy by reforming the taxation of income from capital investments.

One of the bill's primary accomplishments is the reduction in personal and corporate marginal tax rates. The committee bill reduces the top personal income tax rate from 50 percent to 38 percent. Nearly all taxpayers in lower tax brackets will also experi-

ence marginal tax rate reductions. The top corporate rate is similarly reduced from 46 percent to 36 percent. These rate reductions will increase the returns to saving and investment, as well as the after-tax returns to entrepreneurial initiative and productive work effort. The committee's actions in broadening the tax base, by eliminating inefficient tax provisions and curtailing abuses, allow these rate reductions.

Another significant accomplishment of the bill is to provide for more equal taxation of diverse economic activity. The tax system can reduce the efficiency of the economy by not taxing all business sectors similarly. Excessive tax preferences for certain industries result in too much investment in those industries and force other industries to pay too high of a tax burden. The total output obtainable from the economy's stock of capital is maximized when investment is taxed equally in all sectors.

The committee bill improves the efficiency with which investment is allocated by providing a depreciation system that more accurately reflects the actual productive lives of equipment and structures, while retaining incentives for investment in productive plant and equipment. Additionally, the committee has repealed the investment tax credit, which had created a bias against investment in plant and favored investment in quickly depreciating equipment over longer-lived assets. Provisions favorable to a variety of industries that currently allow the deferral of income for tax purposes or that result in excess deductions have been modified by the committee to measure more accurately the economic accrual of income.

The committee bill restricts tax benefits available to oil and gas. The percentage depletion method is phased-out for all oil and gas wells other than stripper wells owned by independent producers and royalty owners. This phase-out of percentage depletion method will not reduce the incentive for oil and gas exploration due to the large tax rate reductions. Given the importance of energy resources for our national security, the committee wishes to provide an incentive to operate marginal wells for longer periods by maintaining the current depletion allowance for certain stripper wells, rather than losing these wells through premature shutdowns. The committee has also extended the period over which intangible drilling costs are deducted to reflect more closely the productive period of these investments. The committee believes that, despite these restrictions, incentives for oil and gas exploration remain high.

The committee bill makes several modifications to the treatment of foreign income. The committee desires to limit the present law incentives for firms to move income offshore. The changes made by the committee bill limit the ability of firms to use tax havens and other devices to reduce U.S. taxes on U.S. income.

The committee has also taken steps to limit the unintended tax incentives that favor mergers and acquisitions. Many of these transactions are highly leveraged due to the favorable tax treatment of debt relative to equity. The lower corporate marginal rates provided by the bill reduce the benefit derived from deducting interest payments, thereby lessening the existing incentive to finance acquisitions through the issuance of high yielding, low quality debt instruments. Another feature reducing the incentive for debt finance is a new provision that permits a corporate tax deduction for

a portion of dividends paid. The bill also repeals the *General Utilities* doctrine, which allows gains from corporate liquidations to escape tax at the corporate level. The *General Utilities* doctrine created a bias favoring acquisitions as a technique for tax-free realization of corporate gains and at the same time achieving a higher basis for purposes of depreciation and depletion. The bill additionally reduces the incentive for tax-motivated corporate acquisitions by limiting the use of net operating losses obtained through an acquisition to offset income of the acquiring firm.

The committee has maintained incentives that were found to continue to promote useful objectives and that were highly valued by many taxpayers. For individual taxpayers, the committee has retained the preferential treatment of capital gains and the deductions for State and local taxes, medical expenses, casualty losses, and charitable contributions. Moreover, the bill permanently allows taxpayers who do not itemize deductions to deduct charitable contributions in excess of $100. Interest paid on mortgages of up to two residences remains deductible, as well as the first $20,000 ($10,000 for single returns) of nonbusiness interest paid in excess of net investment income. The child care credit is also retained.

Given the importance of small business in providing new jobs and in improving the productivity of the economy through innovations, the committee wishes to encourage these fruitful enterprises. The reduction in personal income tax rates and the reduced and graduated corporate income tax schedule benefit small business partnerships, proprietorships, and corporations. The reduction in tax rates is intended to encourage small business capital formation and entrepreneurial innovation. The administrative burden in complying with certain tax provisions is also believed to be proportionately larger for small firms. The committee bill provides a simplified inventory accounting method for small business to relieve these businesses from some of the complexity of the tax code. Small business is also exempted from some of the new restrictions adopted by the committee.

The committee has preserved a number of other business incentives that were found to be beneficial to the economy and society. In general, given the tax rate reductions, the rates of credits and certain other incentives can be reduced and still offset tax liability on the same amount of income. The research and development credit is retained at a reduced rate of 20 percent. The social benefits and increases in productivity from the knowledge obtained through research and development are widespread. Because the private return from research may be less than the benefits to society, the credit helps ensure that sufficient research and development is undertaken. The targeted jobs credit, which encourages businesses to hire economically disadvantaged and disabled individuals, is also retained at a reduced rate for two years. This program offers productive opportunities to many individuals who otherwise might not find work.

The rehabilitation credit has been shown to encourage the preservation and restoration of older buildings and the revitalization of commercial and residential areas. The committee believes it is important to maintain the incentive to preserve our historic past and has continued this tax credit at a reduced rate.

The committee is also concerned about the proliferation of tax-exempt financing for nongovernmental purposes. Tax-exempt bonds for private activities promote an inefficient allocation of capital and increase the cost of financing traditional government activities. The committee bill places limits on the types of nongovernmental activities that may be financed through tax-exempt bonds. The committee believes it is important to allow tax-exempt financing for certain specified types of nongovernmental activities, but has placed limits on the overall volume of most nongovernmental bonds.

In conclusion, the committee believes the changes made by the bill will result in a fairer distribution of the tax liability and a more efficient allocation of the economy's resources. The committee has carefully preserved incentives that are truly beneficial, while curtailing provisions found to be ineffective or abusive. This bill earns the confidence of Americans in our tax system by restoring the principles of equity and evenhandedness.

IV. REVENUE EFFECTS

Tables IV–1 and IV–2, following, present estimated revenue effects of the committee bill for fiscal years 1986–1990. Each of the tables gives amounts by title of the bill and by effect on individual, corporate, excise, and estate and gift tax receipts. Table IV shows more detailed estimates by provision within each title.

Over the five-year period, 1986–1990, the committee tax reform bill is estimated to be close to revenue neutral, reducing total revenues by $364 million (or by less than 0.1 percent of total estimated tax revenues) over the five-year period.

Table IV-1.—Summary of Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-1990

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
I. Individual Income Tax Provisions						
Individual	−15,076	−39,894	−53,555	−57,640	−63,523	−229,688
Corporate	668	1,070	1,117	1,246	1,346	5,447
Total	−14,408	−38,824	−52,438	−56,394	−62,177	−224,241
II. Capital Income Provisions						
Individual	1,295	3,818	5,740	8,275	12,264	31,392
Corporate	9,064	17,179	23,531	29,842	39,799	119,415
Excise	−2	−3	−3	−1	.....	−9
Total	10,357	20,994	29,268	38,116	52,062	150,797
III. Corporate Provisions						
Individual	227	618	593	539	539	2,516
Corporate	−5,531	−15,958	−20,988	−21,662	−21,999	−86,138
Total	−5,304	−15,340	−20,395	−21,123	−21,460	−83,622
IV. Tax Shelters						
Individual	28	129	234	363	460	1,214
Corporate	−26	−65	−140	−212	−311	−754
Total	2	64	94	151	149	460
V. Minimum Tax Provisions						
Individual	800	4,255	5,170	4,679	4,235	19,139
Corporate	1,171	1,551	909	920	1,247	5,798
Total	1,971	5,806	6,079	5,599	5,482	24,937
VI. Foreign Tax Provisions						
Individual	22	38	42	49	52	203
Corporate	979	1,647	2,222	2,899	3,376	11,123

Table IV-1.—Summary of Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-1990—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Excise	23	39	44	49	55	210
Total	1,024	1,724	2,308	2,997	3,483	11,536
VII. Tax-Exempt Bonds						
Individual	118	461	799	1,025	1,269	3,672
Corporate	14	−66	−162	−194	−169	−577
Total	132	395	637	831	1,100	3,095
VIII. Financial Institutions						
Individual	−43	−192	−406	−619	−836	−2,096
Corporate	944	1,476	1,389	1,484	1,803	7,096
Total	901	1,284	983	865	967	5,000
IX. Accounting Provisions						
Individual	602	1,639	1,401	1,696	1,503	6,841
Corporate	6,147	11,864	15,399	14,285	12,288	59,983
Total	6,749	13,503	16,800	15,981	13,791	66,824
X. Insurance Products and Companies						
Individual	2	5	5	5	5	22
Corporate	979	1,891	2,193	2,547	2,855	10,465
Total	981	1,896	2,198	2,552	2,860	10,487
XI. Pensions and Deferred Compensation; Fringe Benefits; ESOPs						
Individual	851	2,262	3,662	4,851	5,594	17,220
Corporate	1,065	2,132	1,405	740	595	5,937
Excise	20	56	58	60	62	256
Total	1,936	4,450	5,125	5,651	6,251	23,413

XII. Minor Children; Trusts and Estates; GST						
Individual	194	617	634	703	789	2,937
Estate and gift		−3	−7	−7	−8	−25
Total	194	614	627	696	781	2,912
XIII. Compliance and Tax Administration						
Individual	2,840	847	1,014	1,091	1,263	7,055
Corporate	110	239	270	187	392	1,198
Excise	13	8	8	8	8	45
Estate and gift	12	12	12	12	12	60
Total	2,975	1,106	1,304	1,298	1,675	8,358
XIV. Miscellaneous Provisions						
Individual	(*)	(*)	(*)	(*)	(*)	(*)
Corporate	−8	−17	−18	−19	−21	−83
Excise				10	15	25
Total	−8	−17	−18	−9	−6	−58
XV. Technical Corrections						
Individual	−182	−18	−17	−14	−13	−244
Corporate	−2	(*)	−22	−24	(*)	−48
Excise	10	5	5	5	5	30
Total	−174	−13	−34	−33	−8	−262
Totals:						
Individual	**−8,322**	**−25,415**	**−34,684**	**−34,997**	**−36,400**	**−139,818**
Corporate	**15,574**	**22,943**	**27,105**	**32,039**	**41,201**	**138,862**
Excise	**64**	**105**	**112**	**131**	**145**	**557**
Estate and gift	**12**	**9**	**5**	**5**	**4**	**35**
Grand total	**7,328**	**−2,358**	**−7,462**	**−2,822**	**4,950**	**−364**

*Loss of less than $5 million.

NOTE.—Detail does not add to total due to rounding.

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Title I—Individual Income Tax Provisions						
Rate changes [4]	−5,827	−24,875	−31,527	−33,944	−38,004	−134,177
Increase in standard deduction	−4,940	−6,433	−6,630	−7,061	−7,521	−32,585
Repeal the additional exemption for the blind and elderly; increase the taxpayer and dependent exemption to $2000	−9,190	−27,646	−34,445	−36,847	−39,415	−147,543
Floor under itemized deductions	1,868	7,494	9,784	10,501	11,270	40,917
Increase the earned income tax credit [5]	−48	−1,435	−3,017	−3,422	−3,844	−11,766
Repeal political contribution credit		257	265	274	284	1,080
Limit employer provided child care to $5000	(1)	(1)	(1)	(1)	(1)	(3)
Taxation of unemployment compensation		220	724	700	682	2,326
Limit exclusion of scholarships and fellowships	10	74	146	180	184	594
Repeal exclusion of prizes and awards	(1)	(1)	(1)	(1)	(1)	(3)
Repeal second earner deduction	1,420	6,141	6,113	6,466	6,840	26,980
Miscellaneous itemized deductions, employee business expense	430	2,895	3,075	3,287	3,515	13,202
Extend charitable contributions deduction for non-itemizers	134	679	−1,048	−1,117	−1,192	−2,544
Repeal deduction for special needs adoption expenses [6]		1	8	9	9	27
Repeal income averaging	477	1,777	1,993	2,216	2,463	8,926
Limitations on deductions for meals, travel, and entertainment:						
Individual	590	957	1,004	1,118	1,206	4,875
Corporate	668	1,070	1,117	1,246	1,346	5,447
Housing allowances for clergy and military personnel	(2)	(2)	(2)	(2)	(2)	(3)
Subtotal, Individual Income Tax:						
Individual	**−15,076**	**−39,894**	**−53,555**	**−57,640**	**−63,523**	**−229,688**
Corporate	**668**	**1,070**	**1,117**	**1,246**	**1,346**	**5,447**
Total	**−14,408**	**−38,824**	**−52,438**	**−56,394**	**−62,177**	**−224,241**

Title II—Capital Income Provisions						
Depreciation, expensing:						
Individual	−36	54	778	1,068	3,329	5,193
Corporate	−304	−477	2,093	6,432	12,082	19,826
Repeal finance leasing:						
Corporate	−23	−46	102	346	499	878
Repeal investment tax credit:						
Individual	1,183	3,445	4,253	6,100	7,489	22,470
Corporate	9,171	17,728	21,583	22,815	26,506	97,803
Credit limitations:						
Corporate	315	454	312	163	67	1,311
Repeal 5-year amortization of trademark expenses:						
Individual	1	3	7	12	18	41
Corporate	2	7	15	25	36	85
Repeal 5-year amortization of pollution control equipment:						
Corporate	(1)	(1)	(1)	(1)	(1)	(3)
Retain 5-year amortization of expenditures for rehabilitation of low income rental housing:						
Individual	(1)	−1	−1	−4	−9	−15
Corporate	(1)	−1	−2	−9	−13	−25
Repeal 50-year amortization of railroad tunnels and bores:						
Corporate	(1)	(1)	(1)	(1)	(1)	(3)
Extension of treatment for removal of architectural barriers:						
Corporate	−9	−17	−8	(2)	.....	−34
Extend modified credit for research and experimentation:						
Individual	−25	−72	−83	−64	−20	−264
Corporate	−449	−902	−1,116	−804	−446	−3,717
Modify rehabilitation tax credit:						
Individual	20	138	361	559	731	1,809
Corporate	12	73	161	238	315	799
Merchant Marine Capital Construction Fund:						
Corporate	3	5	4	4	4	20
Capital gains treatment of coal and iron royalties:						
Individual	15	40	53	78	96	282
Corporate	−6	−8	−6	−2	.....	−22
Intangible drilling costs:						
Individual	39	80	30	11	12	172
Corporate	393	402	121	60	73	1,049
Oil, gas, geothermal depletion:						
Individual	140	373	500	584	610	2,207

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Corporate	43	107	172	206	217	745
Hard minerals depletion:						
Individual	2	7	11	15	15	59
Corporate	68	176	302	382	419	1,347
Mining exploration and development costs:						
Corporate	14	40	63	66	49	232
Energy credits and related incentives:						
Individual	−16	−159	−98	−84	−8	−365
Corporate	−18	−28	−24	−6	4	−72
Excise	−2	−3	−3	−1	.....	−9
Targeted jobs tax credit:						
Individual	−28	−90	−71	.....	.....	−189
Corporate	−148	334	−233	−67	−13	−795
Orphan drug credit:						
Corporate	.....	.....	−8	−7	.....	−15
Subtotal, Capital Income:						
Individual	**1,295**	**3,818**	**5,740**	**8,275**	**12,264**	**31,392**
Corporate	**9,064**	**17,179**	**23,531**	**29,842**	**39,799**	**119,415**
Excise	**−2**	**−3**	**−3**	**−1**	.....	**−9**
Total	**10,357**	**20,994**	**29,268**	**38,116**	**52,062**	**150,797**
Title III—Corporate Provisions						
Corporate rate changes: [4]						
Corporate	−5,186	−15,691	−21,181	−22,382	−23,352	−87,797
Dividends paid deduction:						
Individual	.....	3	−4	−9	52	42
Corporate	.....	−36	−303	−765	−1,290	−2,394
Dividends received deduction:						
Corporate	139	224	252	311	373	1,299

Repeal partial exclusion of dividends received by individuals:						
Individual	199	558	597	625	659	2,638
NOL provisions:						
Corporate	16	43	73	106	136	374
Recognition of gain and loss in liquidations:						
Individual	28	57	.....	−77	−172	−164
Corporate	−500	−498	171	1,068	2,139	2,380
Subtotal, Corporate:						
Individual	**227**	**618**	**593**	**539**	**539**	**2,516**
Corporate	**−5,531**	**−15,958**	**−20,988**	**−21,662**	**−21,999**	**−86,138**
Total	**−5,304**	**−15,340**	**−20,395**	**−21,123**	**−21,460**	**−83,622**
Title IV—Tax Shelters						
Extension of at risk limitations to real property:						
Individual	19	67	138	236	333	793
Corporate	−26	−65	−140	−212	−311	−754
Limitation on deduction for nonbusiness interest:						
Individual	9	62	96	127	127	421
Subtotal, Tax Shelters:						
Individual	**28**	**129**	**234**	**363**	**460**	**1,214**
Corporate	**−26**	**−65**	**−140**	**−212**	**−311**	**−754**
Total	**2**	**64**	**94**	**151**	**149**	**460**
Title V—Minimum Tax:						
Revise the alternative minimum tax:						
Individual	800	4,255	5,170	4,679	4,235	19,139
Revise corporate minimum tax:						
Corporate	1,171	1,551	909	920	1,247	5,798
Total	**1,971**	**5,806**	**6,079**	**5,599**	**5,482**	**24,937**
Title VI—Foreign Tax Provisions						
Foreign tax credit limitation:						
Corporate	275	466	452	482	514	2,189
Creditability of gross withholding tax:						
Corporate	59	94	83	241	295	772
Deemed paid credit:						
Corporate	6	21	64	91	103	285

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Income from sale of property:						
Corporate	170	332	379	405	432	1,718
Transportation income:						
Corporate	190	117	81	87	94	569
Dividend and interest income:						
Corporate	12	20	22	24	27	105
Allocation of interest and other expenses:						
Corporate	172	434	689	885	1,148	3,328
Allocation of R&D expenses:						
Corporate	−243	−436	−160			−839
Tax haven income:						
Corporate	132	228	223	246	271	1,100
Determination of U.S. control:						
Corporate	16	32	33	34	40	155
De minimis tax haven income rule:						
Corporate	19	33	33	37	39	161
Foreign investment companies:						
Corporate	10	18	17	19	21	85
Possessions tax credit and income from intangibles:						
Corporate	57	112	131	161	192	653
Foreign Sales Corporations (FSC):						
Corporate	70	120	115	121	127	553
Private sector earnings of Americans abroad:						
Individual	22	38	42	49	52	203
Branch level tax:						
Corporate	16	27	31	34	37	145
Tax on foreign insurers:						
Excise	23	39	44	49	55	210
Foreign currency gain or loss:						
Corporate	18	29	29	32	36	144

Subtotal, Foreign Tax:						
Individual	22	38	42	49	52	203
Corporate	979	1,647	2,222	2,899	3,376	11,123
Excise	23	39	44	49	55	210
Total	1,024	1,724	2,308	2,997	3,483	11,536
Title VII—Tax-Exempt Bonds						
Subtotal, Tax-Exempt Bonds:						
Individual	118	461	799	1,025	1,269	3,672
Corporate	14	−66	−162	−194	−169	−577
Total	132	395	637	831	1,100	3,095
Title VIII—Financial Institutions						
Limitation on bad debt reserves:						
Corporate	468	828	712	600	700	3,308
Disallow interest incurred to carry tax-exempt bonds:						
Individual	−41	−191	−405	−618	−835	−2,090
Corporate	70	252	477	701	930	2,430
Repeal special carryover rules for depository institutions:						
Corporate	(1)	(1)	(1)	(1)	(1)	(3)
Repeal special reorganization rules for troubled thrifts:						
Corporate	408	397	201	184	174	1,364
Deposits in failed financial institutions:						
Individual	−2	−1	−1	−1	−1	−6
Corporate	−2	−1	−1	−1	−1	−6
Subtotal, Financial:						
Individual	**−43**	**−192**	**−406**	**−619**	**−836**	**−2,096**
Corporate	**944**	**1,476**	**1,389**	**1,484**	**1,803**	**7,096**
Total	**901**	**1,284**	**983**	**865**	**967**	**5,000**
Title IX—Accounting Provisions						
Simplified LIFO for certain small businesses:						
Individual		−10	−38	−50	−60	−158
Corporate		−201	−384	−514	−637	−1,736
Limitation on use of cash accounting method:						
Corporate	267	560	596	610	636	2,669
Recognition of gain on pledges of installment obligations:						
Individual	38	145	283	443	292	1,201

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Corporate	715	737	1,311	1,104	608	4,475
Match expense and income from multiperiod production:						
Individual	181	677	977	1,119	1,081	4,035
Corporate	3,738	8,865	12,270	11,447	10,035	46,355
Repeal of reserve for bad debt for nonfinancial businesses:						
Individual	31	91	86	89	90	387
Corporate	945	1,478	1,446	1,488	1,502	6,859
Limitation on accrual of vacation pay:						
Individual	4	8	2	1	2	17
Corporate	77	66	18	16	18	194
Contributions in aid of construction:						
Corporate	88	128	108	99	91	514
Repeal 84-month amortization, 10% credit for reforestation:						
Individual	(1)	(1)	(1)	(1)	(1)	(1)
Corporate	(1)	(1)	(1)	(1)	(1)	(1)
Capital gains treatment of timber income:						
Individual	1	11	23	24	26	85
Limit expensing of conservation expenditures and repeal expensing of fertilizer and field clearing expenditures:						
Individual	347	717	68	70	72	1,274
Corporate	317	231	34	35	36	653
Subtotal, Accounting:						
Individual	**602**	**1,639**	**1,401**	**1,696**	**1,503**	**6,841**
Corporate	**6,147**	**11,864**	**15,399**	**14,285**	**12,288**	**59,983**
Total	**6,749**	**13,503**	**16,800**	**15,981**	**13,791**	**66,824**
Title X—Insurance Products and Companies						
Policy holder issues:						
Individual	2	5	5	5	5	22

Life insurance company provisions:						
Corporate	401	695	748	802	860	3,506
Repeal tax exemption for certain life insurance companies:						
Corporate	222	453	465	440	404	1,984
Property and Casualty (P&C) insurance provisions:						
Corporate	299	692	951	1,283	1,591	4,816
Repeal P&C insurance company deduction for addition to protection against loss accounts:						
Corporate	74	109	86	65	41	375
Small P&C company provision:						
Corporate	−17	−58	−57	−43	−41	−216
Subtotal, Insurance:						
Individual	**2**	**5**	**5**	**5**	**5**	**22**
Corporate	**979**	**1,891**	**2,193**	**2,547**	**2,855**	**10,465**
Total	**981**	**1,896**	**2,198**	**2,552**	**2,860**	**10,487**
Title XI—Pensions and Deferred Compensation; Fringe Benefits; ESOPs						
Allow spousal IRA for earnings less than $250:						
Individual	(2)	(2)	(2)	(2)	(2)	(3)
Modify cash and deferred arrangements (CODAs) $7000 cap:						
Individual	551	1,008	966	1,115	1,304	4,944
Reduce Section 415 limits:						
Individual	117	323	357	408	468	1,673
Uniform distribution requirements:						
Individual	(1)	(1)	(1)	(1)	(1)	(3)
Excise		(1)	(1)	(1)	(1)	(3)
Replace 10-year averaging with limited 5-year averaging:						
Individual	27	52	97	157	223	556
Repeal 3-year basis recovery rule for contributory plans:						
Individual	134	813	1,869	2,363	2,365	7,544
Tax on pre-retirement distributions, uniform basis recovery rules:						
Individual	120	125	251	587	985	2,068
Adjustments to Section 404 limitations:						
Individual	18	48	51	56	62	235
Excise		(1)	(1)	(1)	(1)	(3)
Tax on qualified plan reversions:						
Excise	20	30	30	30	30	140
Tax on excess retirement distribution:						
Excise		26	28	30	32	116

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Loan provision:						
Individual	1	3	6	7	11	28
Repeal exclusion of current annuity income of corporations:						
Corporate	3	15	34	54	73	179
Two-year extension of the exclusion for group legal plans:						
Individual	−44	−75	−24			−143
Two-year extension of the exclusion for education assistance:						
Individual	−73	−106	−36			−215
Discrimination rules for employee benefits:						
Individual		71	125	138	151	485
ESOP provisions:						
Individual				20	25	45
Corporate	1,062	2,117	1,371	686	522	5,758
Subtotal, Pensions; Fringe Benefits; ESOPs:						
Individual	**851**	**2,262**	**3,662**	**4,851**	**5,594**	**17,220**
Corporate	**1,065**	**2,132**	**1,405**	**740**	**595**	**5,937**
Excise	**20**	**56**	**58**	**60**	**62**	**256**
Total	**1,936**	**4,450**	**5,125**	**5,651**	**6,251**	**23,413**
Title XII—Unearned Income of Minor Children; Trusts and Estates; GST						
Tax unearned income of certain minor children at parent's rate:						
Individual	97	292	300	330	363	1,382
Revise taxation of trusts and estates:						
Individual	97	325	334	373	426	1,555
Generation-skipping transfer tax:						
Estate and gift		−3	−7	−7	−8	−25
Subtotal, Trusts and Estates:						
Individual	**194**	**617**	**634**	**703**	**789**	**2,937**
Estate and gift		**−3**	**−7**	**−7**	**−8**	**−25**

Total	194	614	627	696	781	2,912
Title XIII—Compliance and Tax Administration [7]						
Penalty provisions:						
Individual	308	313	320	326	332	1,599
Corporate	32	34	37	40	42	185
Estate and gift	12	12	12	12	12	60
Excise	8	8	8	8	8	40
Revise estimated tax rules:						
Individual	2,450	220	230	235	240	3,375
Interest rate provisions:						
Individual	39	109	90	77	202	517
Corporate	78	205	163	142	345	933
Information reporting provisions:						
Individual	43	205	454	458	494	1,644
Diesel fuel tax collection:						
Excise	5	(1)	(1)	(1)	(1)	5
Subtotal, Compliance and Administration:						
Individual	2,840	847	1,014	1,091	1,263	7,055
Corporate	110	239	270	187	392	1,198
Excise	13	8	8	8	8	45
Estate and gift	12	12	12	12	12	60
Total	2,975	1,106	1,304	1,298	1,675	8,358
Title XIV—Miscellaneous Provisions						
Exclusion for certain foster care payments:						
Individual	(2)	(2)	(2)	(2)	(2)	(3)
Rules for spouses of individuals missing in action:						
Individual	(2)	(2)	(2)	(2)	(2)	(3)
Olympic Trust Fund excise tax:						
Excise				10	15	25
Distributions of low cost articles and member list rentals:						
Corporate	−4	−7	−8	−9	−11	−39
Interest and tax deductions of cooperative housing corporations:						
Individual	(2)	(2)	(2)	(2)	(2)	(3)
Software royalties and securities dealer interest treatment for the personal holding company tax:						
Corporate	−4	−10	−10	−10	−10	−44

Table IV-2.—Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-90—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Subtotal, Miscellaneous:						
Individual	[2]	[2]	[2]	[2]	[2]	[3]
Corporate	−8	−17	−18	−19	−21	−83
Excise				10	15	25
Total	−8	−17	−18	−9	−6	−58
Title XV—Technical Corrections						
Subtotal, Technical Corrections:						
Individual	−182	−18	−17	−14	−13	−244
Corporate	−2	[2]	−22	−24	[2]	−48
Excise	10	5	5	5	5	30
Total	−174	−13	−34	−33	−8	−262
Total, Individual Income Tax	−8,322	−25,415	−34,684	−34,997	−36,400	−139,818
Total, Corporate Tax	15,574	22,943	27,105	32,039	41,201	138,862
Total, Excise Tax	64	105	112	131	145	557
Total, Estate and Gift Tax	12	9	5	5	4	35
Total, Change in Receipts	7,328	−2,358	−7,462	−2,822	4,950	−364

[1] Gain of less than $5 million.

[2] Loss of less than $5 million.

[3] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[4] Rate change lines include the effects of changes relating to capital gains as well as the interactions between rate changes and other provisions of the bill.

[5] The changes to the earned income credit will reduce revenues by $8 million in 1986, $258 million in 1987, $992 million in 1988, $1,147 million in 1989, and $1,289 million in 1990; and increase outlays by $40 million in 1986, $1,177 million in 1987, $2,025 million in 1988, $2,275 million in 1989, and $2,555 million in 1990.

[6] An outlay of magnitude similar to the amount shown here is anticipated as a result of section 1407, concerning payment of expenses relating to the adoption of children with special needs.

[7] Section 1315 dealing with attorneys' fees is estimated to increase fiscal year outlays by less than $5 million annually.

V. EXPLANATION OF PROVISIONS

Enactment of Internal Revenue Code of 1985

(Sec. 2 of the bill and sec. 7852 and new sec. 7853 of the Code)

Present Law

The last time the internal revenue laws were enacted into law as a whole was in 1954. Since that year, numerous bills have amended the Internal Revenue Code of 1954, but none has enacted the provisions of existing law, together with all amendments, as a new Code.

In general, when a statute and a treaty provision conflict, the one adopted later controls. When Congress enacted the Internal Revenue Code of 1954, it included in that Code (sec. 7852(d)) a statement that no provision of the Internal Revenue title, *i.e.*, the Internal Revenue Code, was to apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). The intent of that provision was to provide a transitional rule to ensure that the substitution of the 1954 Code for the preexisting 1939 Code did not operate to override then-existing treaty provisions.

Reasons for Change

The committee believes that it is appropriate, in light of the historic and fundamental reforms that this bill makes to the present tax laws, to enact the tax laws as amended by this bill as the Internal Revenue Code of 1985.

Reenactment of the rule of section 7852(d)—that no provision of the Internal Revenue title is to apply in any case where its application would be contrary to any treaty obligation in effect on the date of enactment—could lead to an unwarranted inference: that the committee intended to disturb the relationship between existing statutory law and existing treaties.

For example, if the committee had not altered this language, a literal reading of the unaltered language might lead to the inference that the committee intended that existing statutory law that takes priority over existing treaties would thereupon yield priority to treaties. To clarify its intent on this matter, the committee changes the language of section 7852(d).

Explanation of Provision

The bill enacts into law the Internal Revenue Code of 1985. The 1985 Code consists of the provisions of the Internal Revenue Code of 1954 (as in effect immediately before the enactment of the bill), together with the amendments made by this bill. This reenactment

is not intended to change any substantive provisions of the tax law not otherwise modified by this bill.

In connection with this recodification, the committee modifies the 1954 transition rule covering the relationship between treaties and the Code to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls. The bill provides that no provision of the Internal Revenue title that was in effect on August 16, 1954, shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). This provision makes it clear that treaty provisions that were in effect in 1954 and that conflict with the 1954 Code as originally enacted are to prevail over then-existing statutes but not over later-enacted statutes. The committee does not intend that this codification of U.S. tax law affect existing treaty relationships. That is, treaty benefits that are now properly available under the 1954 Code will remain available under the 1985 Code.

Except as mentioned in the bill or this report, the committee is not aware of conflicts between any treaty and the changes (from the 1954 Code as amended) that this bill makes. The committee intends that this bill be interpreted so as not to conflict with the policy embodied in treaties where possible so that the policy goals of both treaties and this bill can be carried out. The committee expects that such harmonious interpretations will be the rule rather than the exception. In any event, the committee is making substantive modifications to present law with clear policies in mind, and does not intent those policies to be defeated by literal interpretations of existing treaties.

Effective Date

This provision is to become effective on the date of the bill's enactment.

TITLE I—INDIVIDUAL INCOME TAX PROVISIONS

A. Basic Rate Structure:

Rate Reductions; Increase in Standard Deduction and Personal Exemptions; Repeal of Two-Earner Deduction (secs. 101-103 and 131 of the bill and secs. 1, 63, 151, and 221 of the Code)

Present Law

Tax rates

Filing status classifications

Different tax rate schedules are provided in present law for each of four filing status classifications: (1) married individuals filing jointly and certain surviving spouses; (2) heads of household; (3) single individuals; and (4) married individuals filing separately.[1]

The term "head of household" means an unmarried individual (other than a surviving spouse) who pays more than half of the household expenses for himself or herself and a child or dependent relative who lives with the taxpayer, or for the taxpayer's dependent parents. A "surviving spouse," who may use the schedule for married individuals filing jointly, is an individual whose spouse died during one of the two immediately preceding taxable years and who maintains a household that includes a dependent child.

Computation of tax liability

Tax liability is calculated by applying the tax rate from the appropriate schedule to the individual's taxable income. Taxable income equals adjusted gross income (gross income less certain exclusions and deductions) minus personal exemptions, minus itemized deductions. Individuals who do not itemize deductions are allowed a deduction for charitable contributions, subject to certain limitations. Tax liability calculated from the rate schedules is reduced by applicable tax credits. Tax rate schedules include the zero (tax rate) bracket amount (ZBA) as the first bracket; the ZBA is provided in lieu of the standard deduction. Itemizers may deduct amounts greater than the ZBA.

Under present law, tax rates in each schedule start at 11 percent in the first taxable income bracket above the ZBA and rise to a maximum tax rate of 50 percent in the top bracket. Three of the schedules have 14 tax rates and brackets; the schedule for single individuals has 15 rates and brackets. Each tax rate applies only to income in that bracket. Income greater than the amount defining the upper end of each bracket is taxed at a higher rate.

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[1] For tax purposes, an individual's marital status for a year generally is determined on the last day of the year. If, however, one spouse dies during the year, the other spouse may still be eligible to file a joint return for that year.

For married individuals filing joint returns and for surviving spouses in 1985, the 11-percent bracket starts at $3,540 of taxable income, and the 50-percent bracket at $168,896; for married individuals filing separate returns, the first and last brackets begin at half these amounts, i.e., $1,770 and $84,448, respectively. Those dollar figures are applicable for 1985 and have been indexed to reflect approximately a four-percent inflation rate in the preceding year. For 1986 and later years, present law provides that all dollar figures defining the tax brackets for these and the other rate schedules are to be adjusted annually according to annual percentage changes in the consumer price index.

Unmarried individuals are taxed in 1985 initially at 11 percent on the first $1,150 of taxable income over $2,390, and at 50 percent on taxable income in excess of $85,070. For a head of household, the 11-percent rate also begins at $2,390, and the 50-percent rate at $112,630. The tax rates applicable to a head of household are lower than those applicable to other unmarried individuals on taxable income above $3,540. Thus, a head of household in effect receives a portion of the benefits of the lower rates accorded to a married couple filing a joint return.

Zero bracket amount (standard deduction)

The first positive taxable income bracket (i.e., the 11-percent marginal tax rate bracket) begins just above the ZBA. The ZBA for 1985 is $3,540 for married individuals filing joint returns and for surviving spouses ($1,770 for married individuals filing separately) and $2,390 for single returns, including a head of household. Beginning in 1985, the ZBA amounts are indexed annually for inflation during the preceding year.

The ZBA has been incorporated into the tax tables and tax rate schedules as the first tax bracket with a zero tax rate since 1977. Since the ZBA is the counterpart of the former standard deduction, nonitemizers only have to reduce adjusted gross income (AGI) by the amount of personal exemptions and use the tax table to find the tax liability. The ZBA also serves as a floor under the amount of itemized deductions. Itemizers reduce AGI by personal exemptions and the excess of itemized deductions over the ZBA, in order to avoid doubling the benefit of the ZBA, and then use the tax tables or tax rate schedule to find tax liability.

Personal exemption

The personal exemption for an individual, the individual's spouse, and each dependent is $1,040 for 1985. Under present law, one additional personal exemption is allowed for an individual who is age 65 or older, and for an individual who is blind.

Beginning with 1985, the amount of the personal exemption is indexed annually for inflation during the preceding year. The consumer price index in the one-year period that ended on September 30, 1985, increased by an amount sufficient to raise the personal exemption to $1,080 for 1986. Prior to 1985, the personal exemption amount had been $1,000 during 1979-84, $750 during 1972-78, $675 for 1971, $625 for 1970, and $600 for 1948-69.

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Two-earner deduction

Couples filing a joint return are allowed a deduction when computing adjusted gross income which is equal to 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000, for a maximum deduction of $3,000. This provision has served to reduce the increase in tax liability that occurs when two individuals with relatively equal incomes marry and file a joint return.

Dependents with income

In general, a person with gross income in excess of the personal exemption amount may not be claimed as a dependent on another taxpayer's return, even though the taxpayer satisfies the general support requirement by furnishing over half the dependent's support for the year. However, parents may claim a full dependency exemption for their dependent child who has income above the personal exemption amount, if the dependent child is (1) under age 19, or (2) a full-time student. In addition, an individual, including a child, for whom a dependency exemption may be claimed on another taxpayer's return also may claim a personal exemption on his or her own tax return, but may claim the ZBA only to the extent of his earned income.

Reasons for Change

The committee bill broadens the base of the individual and corporate income taxes considerably, largely for the purpose of reducing marginal tax rates. The net effect of this effort is to allow a considerable tax reduction for individuals. The committee provisions on tax rates for individuals, the standard deduction, and the personal exemption were fashioned to achieve three important objectives: (1) eliminate any income tax burden for families with incomes below the poverty line; (2) provide an equitable distribution of tax reductions for other groups of taxpayers; and (3) design the standard deduction and rate schedules to achieve acceptably low marriage penalties without the need for the complicated deduction for two-earner couples.

Tax threshold

An overriding goal of the committee was to relieve those with the lowest incomes from Federal income tax liability. The committee realized that by increasing the amounts of both the personal exemption and the standard deduction, as well as the earned income credit, the income level at which individuals begin to have tax liability (tax threshold) will be raised sufficiently to free millions of poverty-level individuals from Federal income tax liability. This will restore to the tax system an essential element of fairness which had been eroded since the last increase in the personal exemption in 1978. In addition, the committee bill will reduce the burden of the Federal tax system on families with modest means, who also are subject to payroll taxes and various State and local government taxes. About 6.5 million taxpayers will be relieved of tax liability as a result of these changes.

The ZBA and personal exemption have been unchanged since set at present levels in the Revenue Act of 1978, except for an indexing

adjustment in 1985. Since that time, inflation has reduced the real value of the standard deduction and personal exemption in setting a threshold level below which income is not taxed. Although the rate reductions in 1981 reduced tax liabilities partly in recognition of the burdens of inflation and social security taxes, those reductions did not extend the same adjustments to marginally taxable individuals who previously had not been taxed on the same amounts of real income. The personal exemption increase, the first statutory increase in the exemption since 1978, also contributes to removing the poor from the tax roles. The personal exemption increase also recognizes the significant cost of bringing up children. The benefit of these increases is not confined to the poor, but they reduce the tax burden for all families by raising the tax threshold for everyone.

In the committee bill, all tax thresholds other than that for single individuals are higher than the estimated poverty level for 1987. In Table 1 below, the columns without the earned income credit reflect the fact that the threshold for heads of households is raised proportionately more for them than it is raised for single individuals, married individuals filing jointly, or elderly individuals. In addition, married individuals receive a larger proportionate increase in the threshold than single individuals, in order to offset the effect of the repeal of the two-earner credit. With the addition of the earned income credit to the computation, the tax threshold rises even further for those eligible for the credit. Although the committee is concerned about the tax burden on low-income unmarried individuals, the bill does not raise their tax threshold above the poverty line for two principal reasons. First, further increases in the standard deduction for these taxpayers would cause significant marriage penalties for two single individuals who marry. Second, because the income tax does not combine the income of family members (other than spouses) in computing tax liability and does not recognize economies of sharing household costs with other individuals, income of unmarried individuals is not a good measure of whether or not living conditions of these persons are impoverished. More than two-thirds of all unmarried individuals with income less than $10,000 are under age 25 and thus are likely to be receiving significant support from other family members that is not reflected on the tax return. In addition, the majority of unmarried individuals between ages 25 and 64, inclusive, live with other individuals, and thus share household costs. Thus, within the existing framework of defining the unit of tax liability, the committee believes that the poverty line is not an accurate guide to the true circumstances of the majority of those who file tax returns as unmarried individuals.

Table 1.—Income Tax Thresholds under Present Law and Committee Bill, 1987

Filing status	Family size	Including earned income credit		Without earned income credit		Estimated poverty level
		Present law	Committee bill	Present law	Committee bill	
Single	1	$3,720	$5,040	$3,720	$5,040	$5,962
Joint	2	6,080	8,980	6,080	8,980	7,637
Head of household	2	8,052	11,952	4,840	8,380	7,637
Joint	4	9,739	14,820	8,340	13,160	11,990
Head of household	4	9,152	14,460	7,100	12,560	11,990

NOTE.—These calculations are based on the following assumptions: (1) inflation is equal to the figures forecast by the Congressional Budget Office; (2) families with dependents are eligible for the earned income credit; (3) all income consists of money wages and salaries; and (4) taxpayers are under age 65.

Equitable distribution of tax burden

The committee also believes that it is necessary to provide tax reduction that is distributed equitably among the vast majority of individuals who bear the tax burden. The next three tables show the changes made by the committee in the distribution of the tax burden. These tables reflect the effect of major provisions affecting individuals, including the rate reductions, changes in itemized deductions, and increases in the standard deduction and personal exemption.

Table 2 below shows the changes in tax liabilities and after-tax income of the committee bill from present law among all income classes. The committee bill reduces total tax liability of individuals by 9.0 percent. The largest tax liability reductions occur in the below $10,000 and the $10,000 to $20,000 income classes, reflecting the decision to increase the tax threshold above the poverty line. In the four income classes between $20,000 and $75,000, the committee bill also produces significant reductions in tax liability. The same pattern is reflected in the column which shows the tax liability change as a percentage of social security and income taxes combined. For all taxpayers, the decrease in combined tax liability is 6.6 percent, and the largest deductions still are in the two income classes below $20,000. The last column shows the percentage change in after-tax income, i.e., the increase in individual income after tax. Generally, the committee bill has a neutral distributional effect on after-tax income. Below $100,000, the increases range between 1.0 and 1.2 percent, except for a 1.5-percent increase for incomes from $10,000 to $20,000. The two income classes above $100,000 receive a 1.9 percent increase in after-tax income. For all taxpayers, after-tax income is increased by 1.3 percent.

Table 2.—Percentage Changes in Income Tax Liability and After-Tax Income, by Income Class, 1987

Income class (thousands of 1986 dollars)	Percentage change in income tax liability	Percentage change in social security and income tax liability	Percentage change in after-tax income
Less than $10	−76.0	−18.5	1.0
10–20	−23.4	−12.8	1.5
20–30	−9.9	−6.1	1.0
30–40	−9.0	−5.7	1.0
40–50	−8.7	−5.8	1.2
50–75	−7.4	−5.4	1.2
75–100	−5.7	−4.7	1.2
100–200	−7.3	−6.5	1.9
200 and above	−5.9	−5.7	1.9
Total	−9.0	−6.6	1.3

NOTE.—These figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

Table 3 below shows that individuals with less than $75,000 of income will receive 72 percent of the reduction for individuals; these individuals make up more than 95 percent of income tax filers. The committee bill distributes 28 percent of the total tax reduction among taxpayers with incomes above $75,000.

Table 3.—Distribution of Tax Changes in Committee Bill, by Income Class, 1987

Income class (thousands of 1986 dollars)	Percentage distribution of tax reduction.
Less than $20	21.2
20–75	51.1
75–200	13.6
200 and above	14.1
Total	100.0

NOTE.—Distributional figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

These tables reflect tax cuts for 1987, the first full year in which the changes in the tax rates and standard deduction are fully effective. By virtue of restructuring the tax schedules and broadening the tax base for individuals, the committee bill produces substantial reductions in income tax liabilities.

Table 4.—Average Income Tax Liability and Tax Rate, Under Present Law and Committee Bill, by Income Class, 1987

Income class	Tax liability		Average tax rate	
	Present law	Committee bill	Present law	Committee bill
0–$10,000	$68	$16	1.4	0.3
10,000–20,000	886	678	5.8	4.4
20,000–30,000	2,168	1,954	8.3	7.5
30,000–40,000	3,346	3,045	9.3	8.5
40,000–50,000	5,100	4,658	11.0	10.1
50,000–75,000	8,166	7,563	13.2	12.2
75,000–100,000	14,223	13,407	16.0	15.1
100,000–200,000	28,245	26,196	19.8	18.4
Over 200,000	136,714	128,711	23.5	22.1
Total	3,210	2,919	11.3	10.5

The tax liability of all taxpayers will decline an average of $291, from $3,210 under present law to $2,919 under the committee bill, as shown in Table 4. The average tax rate will fall from 11.3 percent to 10.5 percent. In 6 income classes from $20,000 to $100,000, the tax rate will decline by 0.8 to 1.0 percentage point. In the 2 lowest and 2 highest income classes, average tax rates will decline by 1.1 or 1.4 percentage points.

Rate schedules, ZBA, and standard deduction

The changes in the distribution of the tax burden were made by revising tax rate schedules, converting the zero bracket amount back into the standard deduction, and by increasing the personal exemption amount.

The tax rate schedules in present law are lengthy and more complicated than is desirable. The relatively narrow intervals between taxable income brackets cause an individual's marginal tax rate to be increased in response to relatively small increases in compensation or profits resulting from economic success and improved efficiency.

In its deliberations, the committee sought to modify the present-law rate structure to make the individual income tax fairer and simpler and to reduce disincentives to economic efficiency and growth. Greater simplicity was achieved by reducing the tax rate structures to four taxable income brackets. The four filing statuses were retained because they are the fewest classifications that can be implemented to provide for the distinctive individual and familial circumstances of a diverse population characterized by strong family ties and individualism.

The four-bracket tax structure includes only positive tax rates because the committee decided to delete the present-law ZBA from the tax structure and instead to restore the standard deduction.

The committee understands that many individuals find the ZBA to be confusing and do not view it as a device that simplifies calculation of income tax liability. Under the committee bill, taxpayers will deduct certain expenses (the standard deduction or a total of separately itemized amounts) in order to determine taxable income. Unlike the ZBA, the standard deduction enables the taxpayer to know directly how much income is subject to tax and to understand more clearly that taxable income is the base for determining tax liability.

Further, the difference between the standard deduction for an unmarried head of household and that for a married couple is narrowed, in recognition that the costs of maintaining a household for an unmarried individual and a dependent more closely resemble the situation of a married couple than that of a single individual without children.

The committee modified the provision for the deduction of itemized deductible expenses by placing a floor under the deductible amount. Under present law, there is some inconsistency between the adjustment for family size for nonitemizers and itemizers. Both nonitemizers and itemizers subtract from income personal exemptions for each taxpayer and dependent to reflect the additional costs of larger families. In addition, itemizers may subtract actual expenses for significant expenses which also vary by family size, such as housing costs (interest and property taxes), medical costs and consumer interest. Under present law, therefore, itemizers receive a larger family size adjustment than nonitemizers. In order to achieve more equity between nonitemizers and itemizers, especially in view of the doubling of the personal exemption, the bill provides a floor under itemized deductions equal to $500 times the number of personal exemptions claimed.

The increases in the standard deduction, modifications to specific deduction provisions, and the floor under itemized deductions will simplify the tax system by substantially reducing the number of itemizers. As a result of these changes, about 13 million itemizers will shift to using the standard deduction, a reduction of approximately 30 percent in the number of itemizers relative to present law.

Marriage penalty

The adjustment of the standard deduction and the rate schedule in the committee bill also makes it possible to minimize the marriage penalty while repealing the complicated two-earner deduction. As a result, single individuals who marry will retain more of the total standard deduction for two single individuals than under present law.

Table 5, which follows, presents a comparison of the marriage tax penalty under present law and the committee bill for couples with varying individual income levels. In spite of the repeal of the two-earner deduction, marriage penalties generally are either smaller than present law or only a nominal amount under the committee bill. The only exceptions to this result occur for certain relatively high income couples, e.g., where the two spouses have incomes of $100,000 and $30,000.

Table 5.—Marriage Tax Penalty for Two-Earner Couple Under Present Law and Committee Bill, 1987

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Present law	−$5	−$45	−$133	−$453	−$2,252
Committee bill	165	86	−204	−868	−1,372
$20,000					
Present law	−45	87	258	464	−851
Committee bill	86	261	261	328	−117
$30,000					
Present law	−133	258	523	1,123	186
Committee bill	−204	261	261	1,118	673
$50,000					
Present law	−453	464	1,123	2,393	2,190
Committee bill	−868	328	1,118	2,034	1,920
$100,000					
Present law	−2,252	−851	186	2,190	3,834
Committee bill	−1,372	−117	673	1,920	2,660

NOTE.—The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, that deductible expenses are 22 percent under present law and 21 percent under the committee bill, and that deductible expenses are allocated between spouses in proportion to income.

Elderly and blind taxpayers

The tax burden on elderly or blind taxpayers is eased by the committee bill apart from the effect of rate reductions. The income tax credit for the elderly or disabled is left unchanged from present law. The present-law personal exemptions and ZBA (standard deduction) are restructured by increasing the standard deduction and exemptions (as previously discussed) and eliminating the extra exemption for the elderly and blind. In addition, the higher standard deduction goes into effect one year earlier (in 1986) for elderly or blind individuals than it does for all other taxpayers (in 1987), and it is augmented by an additional $600 for each elderly or blind individual.

Explanation of Provisions

1. Tax rate schedules

The bill provides a completely new tax rate schedule, with four taxable income brackets, for each of the four present-law filing

status. Each of the four new schedules begins at zero taxable income, which reflects the subtraction of the deductions for personal exemptions and the filer's standard deduction amount (which replaces the ZBA) or excess itemized deductions that were made in the calculation of taxable income. The tax rates in each of the schedules are identical at 15, 25, 35, and 38 percent.

The new schedules, shown below, go into full effect for taxable years beginning in 1987. For taxable years beginning in 1986, the Secretary of the Treasury is instructed in the bill to prepare blended tax rate schedules for 1986 tax returns constructed by assuming that present law is in effect for one half of 1986 and that the new rate schedules are in effect for the other half of the year. The blended schedule essentially will adjust the tax liability for the year on any given level of taxable income so that it is the sum of one-half of the tax liability calculated under the present law schedules, and one-half of the tax liability calculated under the new rate schedules. Fiscal year taxpayers will use the same rate schedules as calendar year taxpayers. The rules relating to proration in section 15 will not apply.

Table 6.—Tax Rates and Taxable Income Brackets for Four Filing Status

Tax rates (percent)	Married, filing jointly	Unmarried individual	Head of household	Married, filing separately
15	0–$22,500	0–$12,500	0–$16,000	0–$11,250
25	22,500–43,000	12,500–30,000	16,000–34,000	11,250–21,500
35	43,000–100,000	30,000–60,000	34,000–75,000	21,500–50,000
38	Over 100,000	Over 60,000	Over 75,000	Over 50,000

2. Standard deduction

In the bill, the standard deduction amount, which replaces the ZBA, is increased substantially, and is deducted by a nonitemizer from AGI to determine taxable income. As shown by the table above, taxable income brackets will begin at zero ($0) in the lowest bracket (15 percent).

A different standard deduction amount is provided for each filing status in an amount generally appropriate to a typical filer in each status. The standard deduction amount for each filing status will be higher in 1987, when the increase becomes effective, than the present-law level of the ZBA.

The amount for heads of households is between the amount for joint return filers and the amount for unmarried individuals. Under present law, the ZBA is the same amount for heads of households and unmarried individuals.

The new standard deduction amounts for 1986 and 1987 and zero bracket amounts for 1985 are shown below. For all taxpayers other than the blind or elderly, the standard deduction amounts for

1986—i.e., $3,670 and $2,480—are identical to the indexed ZBA that would be in effect under present law in 1986.

Table 7.—Zero Bracket Amounts and Standard Deduction Amounts in 1985, 1986, and 1987

Filing status	Standard deduction		Zero bracket amount 1985
	1987	1986	
Joint returns	$4,800	$3,670	$3,540
Heads of households	4,200	2,480	2,390
Unmarried individuals	2,950	2,480	2,390

In addition to the increases shown above, the standard deduction amount on each return is increased in the committee bill by an additional $600 for each taxpayer (or spouse) who is age 65 or older, or who is blind. In the case of an individual (or spouse) who is both elderly and blind, the standard deduction is increased by $1,200.

The standard deduction amounts (including the additional amount for the elderly and blind) will be indexed, beginning in 1988, to reflect increases in the consumer price index.

Individuals may continue to deduct the total of their itemized deductions, if the amount is greater than the standard deduction, but under the bill, the itemized total is reduced by an amount equal to $500 times the number of personal exemptions claimed. For example, if itemized deductions of $7,800 are claimed on a return of a four-person family (two spouses and two dependent children), the itemized deductions would be reduced by $2,000; thus, adjusted gross income on the return would be reduced by itemized deductions of $5,800. Beginning in 1987, the $500 will be indexed for inflation.

3. Personal exemption

The personal exemption amount for each individual, individual's spouse, and each dependent is increased to $2,000. Indexing of this amount to reflect increases in the consumer price index will continue, beginning in 1987.

The additional exemption under present law for the elderly and for blind individuals is repealed. As stated above, the standard deduction is increased by $600 for each elderly individual and for each blind individual.

4. Personal exemption and standard deduction for dependents

Limitations will apply with regard to use of the standard deduction or personal exemption by an individual who is eligible to be claimed as a dependent by another taxpayer. In such cases, the dependent may use the standard deduction only to the extent there is earned income; this is similar to the present law rule applicable to the ZBA. Further, in order to avoid the increase in the amount of unearned income of a dependent which otherwise would be offset

by the personal exemption at the higher $2,000 level, the bill provides that only $1,000 of the personal exemption may be used to reduce the taxable amount of unearned income. Thus, the personal exemption of the dependent is limited to the sum of (a) $1,000 and (b) the excess (but not more than $1,000) of (1) the amount of earned income over (2) the standard deduction. The $1,000 figures also will be indexed for inflation concurrently with the indexing of the personal exemption amount.

5. Two-earner deduction

The bill repeals the deduction for two-earner married couples. Adjustments made in the standard deduction for married couples filing joint returns and in the relationship of the rate schedules for unmarried individuals and married couples filing joint returns compensate for the repeal of this provision.

6. Indexing

The indexing provision is amended by measuring the annual rate of inflation as the percentage change in the Consumer Price Index from August 31 of a year to August 31 of the succeeding year.

Effective Date

The new tax rate schedules are for taxable years beginning on or after January 1, 1986. Blended tax rate schedules will be prepared by the Secretary for calendar year 1986; these schedules will combine the present law schedules for one-half of 1986 and the new tax rate schedules for the other half of 1986.

For taxable years beginning on or after January 1, 1986, the indexed zero bracket amounts in present law become standard deduction amounts. The increases in the standard deduction amounts are effective for taxable years beginning on or after January 1, 1987. For elderly or blind individuals, the increased standard deduction amounts (including the additional standard deduction amounts for these individuals) are effective for taxable years beginning on or after January 1, 1986, instead of the January 1, 1987, effective date applicable to other taxpayers. The limitation on the amount allowed for the itemized deductions is effective for taxable years beginning on or after January 1, 1986.

The increase in the personal exemption amount is effective for taxable years beginning on or after January 1, 1986.

Repeal of the deduction for two-earner married couples is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

Tax rates

The changes in the income tax rates are estimated to decrease fiscal year budget receipts by $5.8 billion in 1986, $24.9 billion in 1987, $31.5 billion in 1988, $33.9 billion in 1989, and $38.0 billion in 1990.

Standard deduction

The restoration of the standard deduction and increase in standard deduction amounts above the ZBA are estimated to decrease fiscal year budget receipts by $4.9 billion in 1986, $6.4 billion in 1987, $6.6 billion in 1988, $7.1 billion in 1989, and $7.5 billion in 1990.

Floor under itemized deductions

The floor under itemized deductions of $500 per exemption is estimated to increase fiscal year budget receipts by $1.9 billion in 1986, $7.5 billion in 1987, $9.8 billion in 1988, $10.5 billion in 1989, and $11.3 billion in 1990.

Personal exemption

The increase in the personal exemption amount and repeal of the additional exemption for the elderly and blind are estimated to decrease fiscal year budget receipts by $9.2 billion in 1986, $27.6 billion in 1987, $34.4 billion in 1988, $36.8 billion in 1989, and $39.4 billion in 1990.

Two-earner deduction

The repeal of the deduction for two-earner married couples is estimated to increase fiscal year budget receipts by $1.4 billion in 1986, $6.1 billion in 1987, $6.1 billion in 1988, $6.5 billion in 1989, and $6.8 billion in 1990.

B. Provisions Related to Tax Credits

1. Increase in Earned Income Credit (Sec. 111 of the bill and secs. 32 and 3507 of the Code)

Present Law

Under present law, an eligible individual is allowed a refundable income tax credit generally equal to 11 percent of the first $5,000 of earned income, for a maximum credit of $550 (Code sec. 32). The maximum allowable credit is phased down if the individual's adjusted gross income (AGI) or, if greater, earned income, exceeds $6,500; no credit is available for individuals with AGI or earned income equal to or exceeding $11,000.

The credit is available to (1) married individuals filing joint returns who are entitled to a dependency exemption for a child; (2) surviving spouses (who, by definition, must maintain a household for a dependent child); and (3) unmarried heads of households who maintain a household for a child. In each case, the credit is available only if the child resides with the taxpayer.

In order to relieve eligible individuals of the burden of computing the amount of credit to be claimed on their returns, tables are used for determination of the credit amount. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments (sec. 3507).

Reasons for Change

The earned income credit is intended to provide tax relief to low-income working individuals with children and to improve incentives to work. Periodically since its enactment in 1975, the Congress has increased the maximum amount and the phase-out levels of the credit to offset the effects of inflation and social security tax increases.

The committee believes that further increases in the maximum amount and phase-out level of the credit are necessary to offset past inflation and increases in the social security tax. In addition, the committee believes that an automatic adjustment to the credit to reflect future inflation should be provided, just as it is provided for the personal exemption, the standard deduction, and rate brackets, in order to eliminate the reduction in the real value of the credit caused by inflation.

Explanation of Provision

Under the bill, the rate of the earned income credit is increased from 11 percent to 14 percent. Thus, the credit generally equals 14 percent of the first $5,000 of earned income; the maximum allow-

able amount of the earned income credit is increased from $550 to $700.

In addition, the income levels over which the credit is phased out are higher than under present law. For taxable years beginning on or after January 1, 1986, the income level at which phase-down begins is $6,500; thus, no credit will be available for individuals with AGI or earned income of $13,500 or more. For taxable years beginning on or after January 1, 1987, the phase-down begins at income of $9,000; thus, no credit will be available at AGI or earned income exceeding $16,000. Effective for taxable years beginning on or after January 1, 1986, the $5,000 maximum amount of earned income for which the credit is allowed and the $6,500 and $9,000 income levels defining the phase-out of the credit will be adjusted for inflation occurring after the 12-month period ending on August 31, 1984.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $8 million in 1986, $258 million in 1987, $992 million in 1988, $1,147 million in 1989, and $1,289 million in 1990, and to increase fiscal year budget outlays by $40 million in 1986, $1,177 million in 1987, $2,025 million in 1988, $40 million in 1989, and $2,555 million in 1990. (To the extent that the amount of earned income credit exceeds tax liability and thus is refundable, it is treated as an outlay under budget procedures.)

2. Repeal of Political Contributions Tax Credit (Sec. 112 of the bill and sec. 24 of the Code)

Present Law

Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions during the year to political candidates and certain political campaign organizations (Code sec. 24). The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return.

Reasons for Change

The committee believes that this credit has had a relatively insignificant incentive effect on the extent of political contributions of small amounts, and thus has largely failed to achieve its objective of broadening the base of support for political candidates and parties. The committee understands that data compiled by the IRS indicates that a significant percentage of persons claiming the credit have sufficiently high incomes to make contributions in after-tax dollars, without the benefit of the credit. Also, the credit provides no incentive for individuals with no income tax liability for the year.

The committee was informed by Treasury that the credit creates administrative and compliance problems for the IRS. The small credit amount allowable per return under the dollar limitations makes verification costly in relation to the tax liability in issue.

In view of the limited effectiveness and use of the credit, the committee believes that the administrative problems and tax return complexity resulting from the credit outweigh the rationale for retaining it.

Explanation of Provision

The bill repeals the credit for political contributions.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $257 million in 1987, $265 million in 1988, $274 million in 1989, and $284 million in 1990.

C. Provisions Related to Exclusions

1. $5,000 Limit on Dependent Care Assistance Exclusion (Sec. 121 of the bill and sec. 129 of the Code)

Present Law

Present law excludes from an employee's gross income amounts paid or incurred by an employer for dependent care assistance provided under a qualified dependent care assistance program (Code sec. 129). Also, the exclusion is available to self-employed individuals (sole proprietors or partners). A similar exclusion applies for social security tax purposes (sec. 3121(a)(18)).

This exclusion is subject to several limitations: (1) the amount excluded may not exceed the employee's earned income (or, if the employee is married, the lower of the earned income of the employee or the employee's spouse); (2) the exclusion is only provided for expenses for household services or care of qualifying individuals (dependents under the age of 15 or physically or mentally incapacitated dependents or spouses) that are incurred to enable the taxpayer to be gainfully employed; (3) no exclusion is available for amounts paid for qualifying services rendered by the employee's dependent or child of the employee who is under the age of 19; (4) no exclusion is available if the dependent care assistance program discriminates in favor of employees who are officers, owners, or highly compensated individuals (or their dependents); and (5) no exclusion is available if more than 25 percent of the total benefits paid are for the group consisting of employees who own more than five percent of the stock or of the capital or profits interest in the employer (or their spouses or dependents).

Reasons for Change

The committee is concerned about the relationship under present law of the exclusion for employer-provided dependent care assistance and the child care credit. The committee recognizes that the present-law exclusion is more valuable to higher-income taxpayers than the child care credit. Moreover, the committee believes that it is inequitable to provide an unlimited exclusion to individuals whose employers provide dependent care assistance, but a limited tax credit to individuals who are required to pay their own child care expenses.

Consequently, the committee concluded that it is desirable to place a dollar limit on the annual exclusion for employer-provided dependent care assistance benefits to coordinate the exclusion with the tax incentives provided to individuals through the child care credit.

Explanation of Provision

Under the bill, the exclusion for dependent care assistance benefits is limited to $5,000 a year ($2,500 in the case of a married individual filing a separate return). In the case of a married couple filing a joint return, the $5,000 limit applies with respect to the couple in order to effectuate the committee's intent to coordinate the limit on the exclusion with the limit on the amount of child care expenses eligible for the child care credit.

The bill provides a special rule for determining the value of child care in a facility on the employer's premises (on-site facility). Under this rule, the value of the benefit is measured by the value of services provided to employees who actually use the facility.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

2. Treatment of Unemployment Compensation Benefits (Sec. 122 of the bill and sec. 85 of the Code)

Present Law

Present law provides a limited exclusion from income for unemployment compensation benefits paid pursuant to a Federal or State program (Code sec. 85).

If the sum of the individual's unemployment compensation benefits and adjusted gross income (AGI) does not exceed a defined base amount, then no unemployment compensation benefits are included in gross income. The base amount is $12,000, in the case of an unmarried individual; $18,000, in the case of a married couple filing a joint return; and zero, in the case of a married couple filing joint returns. If the sum of unemployment compensation benefits and AGI exceeds the base amount, the amount of unemployment compensation that is included in gross income generally is limited to the lesser of (1) one-half the excess of the individual's (a) AGI plus benefits over (b) the base amount, or (2) the amount of the unemployment compensation benefits received.

Reasons for Change

Present law generally treats all cash wages and similar compensation (such as vacation pay and sick pay) received by an individual as fully taxable, but unemployment compensation benefits as taxable only if the taxpayer's income exceeds specified levels. The committee believes that unemployment compensation benefits, which essentially are wage replacement payments, should be treated for tax purposes in the same manner as wages or other wage-type payments. Also, when wage replacement payments are given more favorable tax treatment than wages, some individuals may be discouraged from returning to work. Repeal of the present-law ex-

clusion contributes to more equal tax treatment of individuals with the same economic income and to tax simplification.

Explanation of Provision

Under the bill, all unemployment compensation benefits are includible in gross income.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $220 million in 1987, $724 million in 1988, $700 million in 1989, and $682 million in 1990.

3. Scholarships and Fellowships (Sec. 123 of the bill and sec. 117 of the Code)

Present Law

General rules

Degree candidates.—As a general rule, an individual who is a degree candidate at a college, university, or other educational institution may exclude from gross income amounts received as a scholarship or fellowship grant (Code sec. 117). This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. Under present law, there is no dollar cap on the amount that may be excluded from income as a scholarship or fellowship grant in the case of a degree candidate.

Other recipients.—For individuals who are not degree candidates, the exclusion is available only for scholarships or fellowship grants made by educational institutions or other tax-exempt organizations described in section 501(c)(3), foreign governments, certain international organizations, or Federal, State, or local government agencies. The exclusion for a nondegree candidate in any one year cannot exceed $300 times the number of months for which the recipient received scholarship or fellowship grant amounts, and no further exclusion is allowed after the nondegree candidate has claimed exclusions for a total of 36 months (i.e., a maximum exclusion of $10,800). However, this dollar limitation does not apply to that portion of scholarships or fellowship grants received by the nondegree candidate for travel, research, clerical help, or equipment.

Definitions.—The terms "scholarship" and "fellowship grant" are not defined in the statute. Treasury regulations define scholarship as an amount paid or allowed to, or for the benefit of, a student to aid in pursuing studies; similarly, a fellowship grant is defined as an amount paid or allowed to, or for the benefit of, an individual to aid in pursuing studies or research (Treas. Reg. sec. 1.117-3).

Performance of services.—Amounts paid to an individual to enable him or her to pursue studies or research are not excludable

from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Reg. sec. 1.117-4(c)). These regulations have been upheld by the U.S. Supreme Court, which described excludable grants as "relatively disinterested, 'no-strings' educational grants, with no requirements of any substantial quid pro quo from the recipients" (*Bingler* v. *Johnson*, 394 U.S. 741 (1969)).

In the case of degree candidates, the statute also provides that the exclusion does not apply to any portion of an otherwise qualifying scholarship or fellowship grant that represents payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the scholarship or fellowship grant (sec. 117(b)(1)). However, under a special rule, such services are not treated as employment for this purpose if all degree candidates must perform such services; in that case, the recipient may exclude the portion of the scholarship or fellowship grant representing compensation for such services.

Another special rule provides that amounts received by an individual as a grant under a Federal program that would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future services as a Federal employee, are not includible in gross income if the individual establishes that the amount was used for qualified tuition and related expenses (sec. 117(c)).

Tuition reduction plans.—Section 117(d) provides that a reduction in tuition provided to an employee of an educational institution is excluded from gross income if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met. P.L. 98-611 provided that, through taxable years ending on or before December 31, 1985, this exclusion also applies to graduate-level education provided by an educational institution to a graduate student who is employed by that institution in teaching or research activities.

Reasons for Change

By extending the exclusion for scholarships or fellowship grants to include amounts which can be used for regular living expenses (such as meals and lodging), present law provides a tax benefit not directly related to educational activities; by contrast, students who are not scholarship recipients must pay for such expenses out of after-tax dollars. The committee believes that the exclusion for scholarships should be targeted specifically for the purpose of educational benefits, and should not encompass other items which would otherwise constitute nondeductible personal expenses. Similarly, the committee believes that, in the case of grants to nondegree candidates for travel, research, etc., that would be deductible as ordinary and necessary business expenses, an exclusion for such expenses is not needed, and the exclusion is not appropriate if the expenses would not be deductible. In addition, under the bill, the

committee has increased the income level at which individuals become subject to tax. Thus, grants of nonexcludable amounts based on financial need may not be subject to tax, if the amounts (together with other income) do not place the recipient above the taxable income threshold.

Under present law, controversies have arisen over whether a particular stipend made in an educational setting constitutes a scholarship or compensation for services. In particular, numerous court cases have involved resident physicians and graduate teaching fellows who seek—often notwithstanding substantial case authority to the contrary—to exclude from income payments received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor. The limitation on the section 117 exclusion made by the bill, and the repeal of the special rule relating to degree candidates who must perform services as a condition of receiving a degree, should lessen these problems.

The committee believes that the section 117 exclusion should not apply to amounts representing payment for teaching, research, or other services by a student required as a condition for receiving a scholarship or tuition reduction. Thus, where cash stipends received by a student who performs services would not be excludable under the bill as a scholarship even if the stipend is used to pay tuition, the exclusion should not become available merely because the compensation takes the form of a tuition reduction otherwise qualifying under section 117(d).

The committee believes that it is inappropriate for recipients of certain Federal grants who are required to perform future services as a Federal employee to obtain special tax treatment which is not available to recipients of other types of grants who are required to perform services as a condition of receiving the grants. Thus, under the bill, the general exclusion rule and the limitations apply equally to all recipients.

Explanation of Provision

In general

The bill limits the section 117 exclusion for degree candidates to the amount of a scholarship or fellowship grant that is required to be used, and in fact is used, for (1) tuition and fees required for enrollment or attendance at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution. For this purpose, the committee intends that amounts of scholarship or fellowship grants received that do not exceed this amount are excludable without the need to trace particular grant dollars to particular expenditures for tuition and equipment, provided that the grant requires the recipient to use the grant funds for such purposes. Amounts received by degree candidates in excess of the amount of qualified tuition and equipment expenses are not excludable under section 117. Similarly, amounts not in excess of qualified tuition and equipment costs, but designated or earmarked for other purposes (such as room and board), are not excludable as a scholarship or fellowship grant.

The bill also repeals the present-law exclusion under section 117 for grants received by nondegree candidates. This provision does not affect whether the section 127 exclusion may apply to employer-provided educational assistance to nondegree candidates, or whether unreimbursed educational expenses of some nondegree candidates may be deductible as trade or business expenses if the requirements of section 162 are met.

Performance of services

The bill repeals the special rule of present law permitting scholarship or fellowship grants received by degree candidates to be excludable, even where such amounts represent payment for services, if all candidates for the particular degree are required to perform such services. Thus, the general rule applies requiring inclusion in gross income of amounts received which represent payment for services required as a condition of receiving the grant.

To prevent circumvention of this general rule, the rule is intended to apply not only to cash amounts received, but also to amounts (representing payment for services) by which the tuition of the person who performs services is reduced, whether or not pursuant to a tuition reduction plan described in section 117(d). The bill therefore explicitly provides that the section 117 exclusion does not apply to that portion of the amount received which represents payment for teaching, research, or other services by the student required as a condition of receiving the scholarship or tuition reduction.

The committee intends that employees who perform required services for which they include in income reasonable compensation should continue to be eligible to exclude the amounts of the tuition reduction. (In addition, section 1161 of the committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill.)

The bill also repeals the special rule permitting the exclusion of certain Federal grants as scholarships or fellowship grants, where the recipient is required to perform future service as a Federal employee. Thus, the general rule applies in such circumstances. If the amount received (or a portion of it) represents payments for past, present, or future services required to be performed as a condition of the grant, then the amount received (or a portion of it) is not excludable. As a result, services performed as a Federal employee are not entitled to more favorable tax treatment than services performed for another employer.

Effective Date

The amendment made by the provision applies to scholarships and fellowships granted after September 25, 1985. Amounts received after September 25, 1985 pursuant to a scholarship or fellowship that was awarded on or before that date are not affected by the provision.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $10 million 1986, $74 million in 1987, $146 million in 1988, $180 million in 1989, and $184 million in 1990.

4. Tax Treatment of Prizes and Awards (Sec. 123(b) of the bill and secs. 74, 102, and 274 of the Code)

Present Law

Under section 74, prizes and awards received by an individual (other than scholarships or fellowship grants)[2] generally are includible in gross income. Treasury Regulations provide that taxable prizes and awards include amounts received from giveaway shows, door prizes, awards in contests of all types, and awards from an employer to an employee in recognition of some achievement in connection with employment.

Section 74(b) provides a special exclusion from income for certain prizes and awards that are received for achievements in fields such as charity, the sciences, and the arts. This exclusion does not apply unless the recipient (1) has not specifically applied for the prize or award (for example, by entering a contest), and (2) is not required to render substantial services as a condition of receiving it. Treasury regulations state that the section 74(b) exclusion does not apply to prizes or awards from an employer to an employee in recognition of some achievement in connection with employment.[3]

While section 74 determines the includibility in income of prizes and awards, the treatment of other items provided by an employer to an employee may be affected by section 61, defining gross income, and section 102, under which gifts may be excluded from gross income. Section 61 provides in part that "gross income means all income from whatever source derived," including compensation for services whether in the form of cash, fringe benefits, or similar items. However, an item transferred from an employer to an employee, other than a prize or award that is includible under section 74, may be excludable from gross income if it qualifies as a gift under section 102.

The U.S. Supreme Court, in a case involving payments made "in a context with business overtones," has defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r* v. *Duberstein*, 363 U.S. 278 (1960)). Under this standard, the Court said, transfers made in connection with employment constitute gifts only in the "extraordinary" instance.[4]

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[2] See description above of the amended exclusion under section 117 for scholarships and fellowship grants.

[3] Treas. Reg. sec. 1.74-1(b). But see *Jones* v. *Comm'r*, 743 F.2d 1429 (9th Cir. 1984), holding that an award from an employer to an employee can qualify for the present-law section 74(b) exclusion under extraordinary circumstances. The court held that the exclusion applied in the case of a prominent scientist who was rewarded by the National Aeronautics and Space Administration (NASA) for lifetime scientific achievement, only part of which was accomplished while the scientist was employed by NASA. No inference is intended as to whether the decision of this case is correct under present law.

[4] Under *Duberstein*, the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constitutes a gift to the recipient is

Continued

Under certain circumstances, if an award to an employee constitutes an excludable gift, the employer's deduction may be limited pursuant to section 274(b). That section expressly defines the term "gift" to mean any amount excludable from gross income under section 102 which is not excludable under another statutory provision.

Section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual from the taxpayer during the taxable year exceeds $25. Under an exception to the $25 limitation, the ceiling on the deduction is $400 in the case of an excludable gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. In addition, the ceiling on the employer's business gift deduction is $1,600 for an excludable employee award for such purposes when provided under a qualified award plan, if the average cost of all plan awards in the year does not exceed $400.

A further rule that may be relevant with respect to a prize or award arises under section 132(e), which provides that de minimis fringe benefits are excludable from income. A de minimis fringe is generally defined as "any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable."

Reasons for Change

Present-law exclusion

Prizes and awards generally increase an individual's net wealth in the same manner as any other receipt of an equivalent amount that adds to the individual's economic well-being. For example, the receipt of an award for scientific or artistic achievement in the amount of $10,000 increases the recipient's net wealth and ability to pay taxes to the same extent as the receipt of $10,000 in wages, dividends, or prizes and awards that are taxable under current law. Accordingly, the committee believes that prizes and awards should generally be includible in income even if received due to achievement in fields such as the arts and sciences.

In addition, the committee is concerned about problems of complexity that have arisen as a result of the present-law exclusion under section 74(b). The questions of what constitutes a qualifying form of achievement, whether an individual took action to enter a contest or proceeding, and whether or not the conditions of receiving a prize or award involve rendering "substantial" services, have all caused some difficulty in this regard. Finally, the present-law exclusion may in some circumstances serve as a possible vehicle for the payment of disguised compensation.

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to be made on a case-by-case basis, by an "objective inquiry" into the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must be included in income by the recipient.

At the same time, the committee recognizes that in some instances an award recipient may wish to assign the award to charity, rather than claiming it for personal use. Accordingly, the bill provides that a prize or award meeting the present-law exclusion requirements under section 74(b) is excludable from gross income if the prize or award is transferred by the payor, pursuant to a designation made by the winner of the prize or award, to a governmental unit or to a tax-exempt charitable organization contributions to which are deductible under section 170(c)(1) or section 170(c)(2), respectively.

Employee awards

An additional reason for change relates to the tax treatment of employee awards of tangible personal property given by reason of length of service, productivity, or safety achievement. These items are not excludable, and the deduction of their cost by the employer is not limited under section 274(b), if they cannot qualify as gifts due either to the "detached generosity" standard applicable under section 102 or to the rule of section 74(a) that prizes and awards generally are includible in income.

The committee understands that uncertainty has arisen among some taxpayers concerning the proper tax treatment of an employee award. This uncertainty could lead some employers to seek to replace amounts of taxable compensation with "award" programs of tangible personal property, which the business and the employee might contend are not subject to income or social security tax. In the case of highly compensated employees, who often may not be significantly inconvenienced by the fact that the awards are made in the form of property rather than cash, an exclusion for transfers of property with respect to regular job performance could serve as a means of providing tax-free compensation.

Accordingly, the committee believes that it is desirable to provide expressly that an award to an employee made for reasons arising out of a business context does not constitute an excludable gift. At the same time, the committee believes that no serious potential abuse arises from transfers by employers to employees of items of low value. Therefore, the committee wishes to clarify that the rule under present law whereby de minimis fringe benefits may be deductible by the employer but are not taxable to the employee can apply to employee awards of low value, including traditional awards (such as a gold watch) upon retirement after lengthy service for an employer.

Explanation of Provision

a. Scientific, etc. awards

Under the bill, the present-law exclusion under section 74(b) is generally repealed. However, a prize or award may qualify for exclusion under section 74(b) as amended by the bill only if (1) it meets the present-law requirements for exclusion and (2) the recipient designates that the prize or award be transferred by the payor to a governmental unit or tax-exempt charitable organization contributions to which are deductible under section 170(c)(1) or 170(c)(2), respectively. In such case, the prize or award is not in-

cluded in the winner's gross income, and no charitable deduction is allowed to the winner or to the payor.

For purposes of determining whether a prize or award that is so designated qualifies as excludable under the bill, the present-law rules concerning the scope of section 74(b) are retained without change. In order to qualify for the exclusion, the designation must be made by the taxpayer, and carried out by the party making the award, before the taxpayer uses the item that is awarded (e.g., in the case of an award of money, before the taxpayer spends, deposits, or otherwise invests the money). Disqualifying uses by the taxpayer include use of the property with the permission of the taxpayer or by one associated with the taxpayer (e.g., a member of the taxpayer's family).

b. Employee awards

Under the provision in the bill relating to employee awards, no amount transferred by or for an employer to, or for the benefit of, an employee may qualify as an excludable gift. Thus, for example, an item awarded in recognition of a work-related achievement (such as length of service, productivity, or safety achievement) cannot qualify as an excludable gift and hence is includible in income.[5] This rule applies whether or not (1) the item constitutes a prize or award, (2) the employer is entitled to deduct its cost, or (3) the item would qualify as a gift if the section 102 standard of "detached generosity" were applicable. In view of this provision, the deduction limitation provisions of section 274 (i.e., section 274(b)(1)(C) and 274(b)(3)) have no application and are therefore repealed.

The committee bill does not modify section 132(e), under which de minimis fringe benefits are excluded from gross income. Thus, an employee award is not includible in income if its fair market value, after taking into account the frequency with which similar benefits are provided by the employer to the employer's employees, is so small as to make accounting for it unreasonable or administratively impracticable.

The committee anticipates that this exception will apply, under appropriate circumstances, to items presented to employees upon retirement. Thus, traditional retirement gifts presented upon retiring after completing lengthy service may qualify as excludable de minimis fringe benefits. For example, in the case of an employee who has worked for the employer for 25 years, a retirement gift of a gold watch may qualify for exclusion as a de minimis fringe benefit even though gold watches given throughout the period of employment could not so qualify for exclusion.

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[5] Of course, gifts between individuals made exclusively for personal reasons (such as birthday presents) that are wholly unrelated to an employment relationship are not includible in the recipient's gross income merely because the gift-giver is the employer of the recipient. A transfer between personal acquaintances will not be considered to have been made exclusively for personal reasons if reflecting any employment-related reason (e.g., gratitude for services rendered) or any anticipation of business benefit. A transfer made exclusively for personal reasons cannot give rise to a deduction under section 162 or section 212.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

D. Provisions Related to Deductions

1. One-Percent Floor on Employee Business Expenses, Investment Expenses, and Other Miscellaneous Itemized Deductions (Sec. 132 of the bill and sec. 62 and new sec. 67 of the Code)

Present Law

In general

The list of itemized deductions on Schedule A of Form 1040 includes a category labeled miscellaneous deductions, following the listings for medical expenses, charitable expenses, interest, taxes, and casualty and theft losses. Under present law, this category generally includes four types of deductions: (1) certain employee business expenses (sec. 162); (2) expenses of producing income (sec. 212); (3) expenses related to filing tax returns (sec. 212); and (4) expenses of adopting children with special needs (sec. 222).

Employee business expenses

An employee business expense is a cost incurred by an employee in the course of performing his or her job. Examples of such costs include unreimbursed expenditures for subscriptions to professional journals or continuing education courses, union or professional dues, costs of professional uniforms, costs of looking for new employment, and expenses allowable for business use of the taxpayer's home. Ordinary and necessary employee business expenses generally are deductible, on the ground that they are costs of earning income.

Employee business expenses generally can be claimed only as itemized deductions. However, four types of employee business expenses are deductible above-the-line in calculating adjusted gross income, and thus are directly available to nonitemizers: (1) expenses paid by an employee and reimbursed by the employer; (2) employee travel expenses incurred while away from home; (3) employee transportation expenses incurred while on business; and (4) business expenses of employees who are outside salespersons. For taxpayers in a trade or business other than being an employee (e.g., as sole proprietors and partners), all business expenses are deductible above-the-line.

Certain deductions for employee business expenses also are subject to specific limitations or restrictions. For example, a taxpayer's business use of his or her home (whether or not the taxpayer is in the business of being an employee) does not give rise to a deduction for the business portion of expenses related to operating the home (e.g., rent, depreciation, and repairs) unless the taxpayer uses a part of the home regularly and exclusively as the principal place of business or as a place of business used by patients, clients, or cus-

tomers (sec. 280A).[6] Educational expenses are deductible only if the education (1) is required by the employer, by law, or by regulations, or (2) maintains or improves skills required to perform the taxpayer's present occupation. Costs of looking for new employment are deductible only if they relate to employment in the taxpayer's present occupation.

Investment expenses

In general, expenses of producing income other than rental or royalty income are treated as itemized deductions if the related activity does not constitute a trade or business. (Trade or business expenses and expenses of producing rental or royalty income are deductible above-the-line.) Among the types of investment expenses that may be eligible, in particular circumstances, for deduction are investment counsel fees, subscriptions to investment advisory publications, and attorneys' fees incurred in collecting income.

Other miscellaneous itemized deductions

Tax counsel and assistance fees, as well as appraisal fees paid to determine the amount of a casualty loss or a charitable contribution of property, may be claimed as itemized deductions (sec. 212(3)). Also, expenses incurred with respect to a hobby—i.e., an activity that may generate some gross income but that the taxpayer conducts for personal recreational reasons, rather than with the goal of earning a profit—are deductible to the extent such expenses would be deductible regardless of profit motivation (e.g., certain interest and taxes) or to the extent of income from the hobby.[7] Gambling losses are deductible to the extent of gambling gains.

Reasons for Change

The committee believes that the present-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fosters significant complexity. For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the Internal Revenue Service. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions.[8]

Since many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the committee believes that the complexity created by present law is undesirable. At the same time, the committee believes that taxpayers with unusually large employee business or investment expenses should be permitted an itemized de-

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[6] See section 143(c) of the bill, amending the rules relating to home office deductions.

[7] See section 143 of the bill, amending the rules relating to hobby losses.

[8] Common taxpayer errors include disregarding the restrictions on home office deductions, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscriptions to widely read publications outlining business information without a sufficient business or investment purpose.

duction reflecting that fact. Similarly, in the case of medical expenses and casualty losses, a floor is provided under present law to limit those deductions to unusual expenditures that may significantly affect the individual's disposable income.

Accordingly, the committee believes that the imposition of a one-percent floor on miscellaneous itemized deductions constitutes a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the percentage floor. Also, the floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

The committee also believes that the distinction under present law between employee business expenses (other than reimbursements) that are allowable above-the-line, and such expenses that are allowable only as itemized deductions, is not supportable. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses.

Explanation of Provision

The bill provides that employee business expenses (including those, other than expenses reimbursed by the employer, that are presently allowable above-the-line) and other miscellaneous itemized deductions are deductible only to the extent that, in the aggregate, they exceed one percent of the taxpayer's adjusted gross income (AGI). The amount of these deductions that exceeds one percent of the taxpayer's AGI is allowable only as an itemized deduction. A special rule applies to determine AGI in the case of trusts or estates.

Other provisions in the bill affect the allowability of particular miscellaneous deductions.[9] To the extent that any limitation is placed on the amount of a miscellaneous deduction, either under present law or under the bill, that limitation applies prior to the application of the one-percent floor. For example, if an employee incurs deductible expenses relating to business meals away from home, and these expenses are not reimbursed by the employer, the employee must first reduce the amount of the expenses by 20 percent (pursuant to section 142 of the bill) and then add the remaining portion of the expenses to the other miscellaneous deductions that he or she has incurred during the year for purposes of applying the one-percent floor. Similarly, the deductibility of expenses relating to a hobby or a home office must first be determined pursuant to the applicable rules before application of the one-percent floor.

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[9] See section 134 of the bill (concerning qualified adoption expenses), section 142 of the bill (travel and entertainment expenses), and section 143 of the bill (home office deductions and hobby losses).

Effective Date

The provision applies to taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $430 million in 1986, $2,895 million in 1987, $3,075 million in 1988, $3,287 million in 1989, and $3,515 million in 1990.

2. Charitable Contribution Deduction for Nonitemizers (Sec. 133 of the bill and sec. 170(i) of the Code)

Present Law

The Economic Recovery Tax Act of 1981 enacted a deduction for charitable contributions made by individuals who do not itemize deductions on their income tax returns, to be phased in over a five-year period and then terminated after 1986 (Code sec. 170(i)).

Under the phase-in, for taxable years beginning in 1982-1984, the amount of contributions that nonitemizers were allowed to take into account was subject to a maximum dollar limit. In addition, for the years 1982-1985, only a portion of the amount of contributions otherwise deductible is allowed as a deduction for nonitemizers. These percentages and dollar limits are shown in the following table:

Year contribution made	Percentage	Contribution limit
1982	25	$100
1983	25	100
1984	25	300
1985	50	None
1986	100	None

Thus, in 1982 and 1983, nonitemizers were allowed to deduct 25 percent of the first $100 of charitable contributions, for a maximum deduction of $25. For 1984, the maximum deduction was $75 (25 percent of a $300 contribution limit).

For 1985 and 1986, nonitemizers may deduct 50 and 100 percent of their charitable contributions, respectively, without regard to a contribution limit (other than the general percentage limitations applicable to charitable contribution deductions). Under present law, nonitemizers will not be able to deduct any amount of charitable contributions made after December 31, 1986.

The Code provides expressly that a charitable contribution is deductible only if verified in the manner required by Treasury regulations (sec. 170(a)(1)). Pursuant to this statutory rule, certain substantiation requirements have been set forth in regulations, including additional information that must be attached to the donor's return in the case of certain donations of property.

Reasons for Change

The bill makes permanent the charitable deduction for nonitemizers in order to stimulate charitable giving by all individual taxpayers, including those who do not benefit from itemizing. The committee believes that the nonitemizer deduction encourages contributions to religious organizations, community groups, and many other charities.

At the same time, the committee recognizes that donations of relatively small amounts (such as regular giving to religious institutions, or small contributions in response to door-to-door solicitations) may occur in the absence of any tax incentive. Also, allowing a nonitemizer deduction for relatively low levels of giving may impose recordkeeping burdens and complexity for many short-form filers, and create enforcement problems for the Internal Revenue Service. Accordingly, the committee has concluded that the nonitemizer deduction should be available only to the extent that the taxpayer's total charitable contributions for the year exceed $100.

Explanation of Provision

The bill makes permanent the deduction (sec. 170(i)) for charitable contributions made by individuals who do not itemize deductions on their income tax returns, but modifies the deduction by providing that for taxable years beginning after December 31, 1985, the deduction is subject to a $100 floor per return. Accordingly, the full amount of charitable contributions (otherwise qualifying for deduction under sec. 170) in excess of $100 per return is deductible by nonitemizers for post-1985 taxable years.

As under present law, the deduction for nonitemizers for post-1985 years will continue to be subject to the tax rules generally applicable to charitable deductions, including the 20/30/50-percent limitations (based on a percentage of the donor's adjusted gross income), the reduction rules applicable to contributions of appreciated property, and the rule that no deduction is allowable (to itemizers or nonitemizers) unless the contribution is substantiated as required by Treasury regulations. Also, as under present law, a charitable deduction for a payment to a charitable organization is allowed only to the extent exceeding the fair market value of any goods or services received in exchange for the payment.

Effective Date

The provision applies to taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $134 million in 1986, and $679 million in 1987, and to decrease fiscal year budget receipts by $1,048 million in 1988, $1,117 million in 1989, and $1,192 million in 1990.

3. Repeal of Deduction for Certain Adoption Expenses (Sec. 134 of the bill and sec. 222 of the Code)

Present Law

The Code (sec. 222) provides an itemized deduction for up to $1,500 of expenses incurred by an individual in the legal adoption of a child with special needs. (This deduction became effective in 1981.) Deductible expenses include reasonable and necessary adoption fees, court costs, and attorney fees.

A "child with special needs" is a child with respect to whom adoption assistance payments may be made under section 473 of the Social Security Act. In general, this is a child who (1) the State has determined cannot or should not be returned to the home of the natural parents, and (2) cannot reasonably be expected to be adopted unless adoption assistance is provided, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap).

Reasons for Change

The committee believes that Federal benefits for families adopting children with special needs more appropriately should be provided through an expenditure program, rather than through an itemized deduction. The deduction provides relatively greater benefits to higher-income taxpayers, who presumably have relatively less need for Federal assistance. Also, the committee believes that the agencies with responsibility and expertise in this area should have direct budgetary control over the assistance provided to families that adopt children with special needs.

Explanation of Provision

The bill repeals the section 222 itemized deduction for adoption expenses. To ensure that families who adopt children with special needs receive appropriate Federal support, section 1407 of the bill (described below) amends the Adoption Assistance Program in Title IV-E of the Social Security Act.

Effective Date

The repeal of the deduction generally is effective for expenses paid or incurred after December 31, 1986. However, the present-law deduction will be applicable to expenses paid during 1987 in connection with an adoption as to which the taxpayer paid expenses during 1986 that were deductible under section 222 (see also the description below of the effective date for section 1407 of the bill).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1 million in 1987, $8 million in 1988, $9 million in 1989, and $9 million in 1990. (See description below of the related Adoption Assistance Program amendments made by section 1407 of the bill, which are anticipated to result in increased budget outlays of comparable magnitude.)

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E. Other Provisions

1. Repeal of Income Averaging (Sec. 141 of the bill and secs. 1301-1305 of the Code)

Present Law

Under the income averaging rules (Code secs. 1301-1305), eligible individuals may reduce their tax liabilities for a year in which their income is at least 40 percent greater than their average income for the immediately preceding three years (the "base years"). In such a case, income averaging reduces tax liability by applying a lower marginal rate than would be used under the regular tax system to a portion of the current year's income.

In order to use income averaging, an individual (1) must meet one of several alternative standards generally intended to restrict the availability of income averaging to individuals who were self-supporting during the base years, and (2) must have been a United States citizen or resident during the taxable year and the three base years. An individual who has not been self-supporting during one or more of the base years nonetheless may be eligible for income averaging if he or she has attained the age of 25 and was not a full-time student during at least four years after attaining the age of 21.

Reasons for Change

The committee believes that other individual income tax provisions of the bill, providing wider brackets with fewer rates and a flatter rate structure, reduce the need for income averaging to the point that there is no longer sufficient justification to retain it in light of its complexity. As a result of the rate structure and other provisions of the committee bill, fluctuations in annual income will not change the taxpayer's marginal tax rate as frequently, and in many cases will not change it as much, as under present law.

The complexities of income averaging under present law derive both from the arithmetical calculations that it requires and also from the rules governing eligibility. For example, the determination of whether an individual was self-supporting during each of the base years can be difficult; this issue has been a frequent source of controversy between individuals and the Internal Revenue Service. In addition, application of the income averaging rules can be particularly complex for an individual whose marital status has changed during one of the three base years.

Explanation of Provision

The bill repeals income averaging.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $477 million in 1986, $1,777 million in 1987, $1,993 million in 1988, $2,216 million in 1989, and $2,463 million in 1990.

2. Limitations on Deductions for Meals, Travel, and Entertainment (Sec. 142 of the bill and secs. 162, 170, 212, 274, and 6653 of the Code)

Present Law

Overview

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income (Code secs. 162, 212). Travel expenses incurred while away from home in the pursuit of a trade or business, including amounts expended for meals and lodging (other than amounts that are lavish or extravagant under the circumstances), generally qualify for the deduction (sec. 162(a)(2)).

The taxpayer bears the burden of proving both the eligibility of an expenditure as a deduction and also the amount of any such eligible expenditure.[10] In addition, certain limitations and special substantiation requirements apply to travel and entertainment deductions (sec. 274). Taxpayers are subject to penalties if any part of an underpayment of tax (e.g., because of improperly claimed deductions) is due to negligence or intentional disregard of rules or regulations (sec. 6653(a)) or due to fraud (sec. 6653(b)).

No deduction is allowed for personal, family, or living expenses (sec. 262). For example, the costs of commuting to and from work are nondeductible personal expenses.[11]

The Code also provides that no deduction is allowed for a payment that is illegal under any Federal law or State law (but only if such State law is generally enforced) that subjects the payor to a criminal penalty or the loss of a license or privilege to engage in a trade or business. For example, if paying more than the face value for a ticket ("scalping") is illegal under an enforced State law, this rule would disallow any otherwise available deduction of such payments as business entertainment expenses.

Entertainment activities

In general

Under present law, expenditures relating to activities generally considered to constitute entertainment, amusement, or recreation are deductible only if the taxpayer establishes that (1) the item was directly related to the active conduct of the taxpayer's business or

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[10] See, e.g., *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943); *Comm'r* v. *Heininger*, 320 U.S. 467 (1943).

[11] *Fausner* v. *Comm'r*, 413 U.S. 838 (1973).

(2), in the case of an item directly preceding or following a substantial and bona fide business discussion, the item was associated with the active conduct of the taxpayer's business. The "directly related" and "associated with" tests are intended to require a more proximate relation between the entertainment expense and the taxpayer's business than would be required under the "ordinary and necessary" requirement applicable to all business expenses (including business entertainment expenses).

These special requirements apply, subject to ten statutory exceptions under present law (including an exception for meals, and discussed in greater detail below), to expenses of the taxpayer and the taxpayer's guests such as expenses incurred at nightclubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, and sporting events, and on hunting, fishing, or vacation trips or yachts, as well as to expenses of providing food or beverages, lodging not used for business purposes, or the personal use of employer-provided automobiles. If either statutory test is met or an exception applies, entertainment expenses of the taxpayer as well as entertainment expenses of the taxpayer's business guests (such as present or potential customers or clients, legal or business advisors, suppliers, etc.) are deductible (assuming all generally applicable requirements are satisfied).

"Directly related" test

The regulations under section 274 provide several alternative tests for satisfying the "directly related" requirement, generally designed to require the taxpayer to show a clear business purpose for the expenditure and a reasonable expectation of business benefits to be derived from the expenditure. For example, under the "active business discussion" test, the taxpayer must have actively engaged in a business meeting during the entertainment period for the purpose of business benefit, and must have had more than a general expectation of deriving some income or other business benefit (other than merely goodwill) at some indefinite future time.

The regulations presume that the "active business discussion" test is not met if the entertainment occurred under circumstances where there was little or no possibility of engaging in business. For example, the test is presumed not to have been met if there were substantial distractions, e.g., because the entertainment took place at a nightclub or a cocktail party, or if the taxpayer met with a group including nonbusiness-related individuals at a vacation resort.

Even if the "active business discussion" test is not met, entertainment expenses are deemed "directly related" to business and hence satisfy the special section 274 limitation if incurred in a "clear business setting" directly in furtherance of the taxpayer's business. For example, the "clear business setting" test is met for expenses of entertainment taking place in a hospitality room at a convention, where business goodwill may be generated through the display of business products, or where civic leaders are entertained at the opening of a new hotel or theatrical production, provided that the clear purpose is to obtain business publicity. However, because of distracting circumstances, entertainment is presumed not to have occurred in a clear business setting in the case of a meet-

ing or discussion taking place at a nightclub, theater, or sporting event, or during a cocktail party.

"Associated with" test

The second category of entertainment expenditures that are deductible under present law are expenses associated with the taxpayer's business that are incurred directly preceding or following a substantial and bona fide business discussion. This test generally permits the deduction of entertainment costs intended to encourage goodwill, where the taxpayer establishes a clear business purpose for the expenditure. Entertainment costs for the taxpayer's spouse, or the spouses of business customers, also may qualify for deduction under this test if meeting the general ordinary and necessary standard.

The "associated with" test does not require that business actually be transacted or discussed during the entertainment, that the discussion and entertainment take place on the same day, that the discussion last for any specified period, or that more time be devoted to business than to entertainment. Thus, if a taxpayer conducts negotiations with a group of business associates and that evening entertains them and their spouses at a restaurant, theater, concert, or sporting event, the entertainment expenses generally are deductible as "associated with" the active conduct of the taxpayer's business, even though the purpose of the entertainment is merely to promote goodwill. Entertainment taking place between business sessions or during evening hours at a convention is treated as directly preceding or following a business discussion.

Entertainment facilities

The section 274 rules were amended by the Revenue Act of 1978 to disallow any deduction (or the investment tax credit) for the cost of entertainment facilities, unless one of the specific statutory exceptions applies. This general disallowance rule applies to property such as luxury "skyboxes" in sports arenas, tennis courts, bowling alleys, yachts, swimming pools, hunting lodges, fishing camps, and vacation resorts.

Dues or fees paid to a social, athletic, or sporting club are deductible provided that more than half the taxpayer's use of the club is in furtherance of the taxpayer's business and the item is directly related to the active conduct of the taxpayer's business. The expenses of box seats and season tickets to theaters and sporting events are not disallowed as expenses related to entertainment facilities. Instead, such costs are fully deductible if they meet the tests applied to entertainment activities. Under present law, the cost of "leasing" a skybox in a sports arena for an entire season or year is treated as an entertainment activity expense, rather than an entertainment facility expense.

Exceptions for certain entertainment

In general

There are ten statutory exceptions to the general section 274 rules that an entertainment, recreation, or amusement activity expenditure must satisfy either the "directly related" or "associated

with" tests, and that entertainment facility costs are not deductible. If an exception applies, the entertainment expenditure is deductible if it is ordinary and necessary and if any applicable section 274(d) substantiation requirements are satisfied.

These exceptions are for (1) business meals (discussed below), (2) food and beverage furnished to employees on the taxpayer's business premises, (3) entertainment expenses treated by the employer and employee as compensation to the employee, (4) expenses paid by the taxpayer under a reimbursement or other expense allowance arrangement in connection with the performance of services, (5) expenses for recreational, social, or similar facilities or activities for the benefit of employees generally, (6) entertainment expenses directly related to bona fide meetings of a taxpayer's employees, stockholders, or directors, (7) entertainment expenses directly related to and necessary to attendance at a business meeting or convention of a tax-exempt trade association, (8) expenditures for entertainment (or a related facility) made available by the taxpayer to the general public, (9) expenses for entertainment sold by the taxpayer to the public, and (10) expenses includible in the income of persons who are not employees.

The regulations under section 274 provide that entertainment expenditures are not deductible to the extent they are lavish or extravagant. The Internal Revenue Service has not interpreted this provision to disallow deductions merely because entertainment expenses exceed a fixed dollar amount, are incurred at expensive restaurants, hotels, nightclubs, or resorts, or because they involve first-class accommodations or services (see Rev. Rul. 63-144, 1963-2 C.B. 129).

Meals

Expenses for food and beverage are deductible, without regard to the "directly related" or "associated with" requirements generally applicable to entertainment expenses, if the meal or drinks take place in an atmosphere conducive to business discussion (sec. 274(e)(1)). In general, the deduction covers both the expenses of the taxpayer's business guest and of the taxpayer, notwithstanding that meal expenses of an individual (unless incurred away from home on a business trip) otherwise are nondeductible personal expenses.

There is no requirement that business actually be discussed either before, during, or after the meal. For example, if the taxpayer takes a potential customer to breakfast, lunch, or dinner at a restaurant or hotel, or to a bar for drinks, the costs of the food and beverages are deductible whether or not any business is discussed. The legislative history of the 1962 Act indicates that this "business meals" exception to section 274(a) thus exempts a significant portion of business "goodwill" entertaining from the restrictions generally applicable to entertainment expenses.

Under the exception, meals in a restaurant or hotel dining room are deductible in the absence of distractions such as floor shows. Business entertaining at the taxpayer's home also qualifies if the taxpayer shows that the expenditure was commercially, rather than socially, motivated. In such situations, expenditures for meals of a customer's spouse, and for the taxpayer's spouse who helps en-

tertain a business customer, are deductible if they meet the general "ordinary and necessary" standard. However, entertainment at a night club, sporting event, or large cocktail party generally does not qualify for the business meal exception.

Travel expenses

Away from home travel

Traveling expenses incurred by the taxpayer while "away from home" in the conduct of a trade or business (e.g., where the taxpayer travels to another city for business reasons and stays there overnight) generally are deductible if the ordinary and necessary standard is met. The "away from home" deduction applies to personal living expenses such as food and lodging incurred during the trip. However, travel deductions for meals and lodging are subject to disallowance if they are "lavish and extravagant" (sec. 162(a)(2)), and must be substantiated pursuant to section 274(d).

Deductions for conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the cruise ship is registered in the United States and stops only at ports of call in this country (including United States possessions) (sec. 274(b)(2)). Also, special rules apply in the case of travel outside the United States that lasts for more than one week (sec. 274(c)).

Traveling costs as deductible education expenses

Traveling expenses may be deductible as business expenses if the travel (1) maintains or improves existing employment skills or is required by the taxpayer's employer or by applicable rules or regulations, and (2) is directly related to the taxpayer's duties in his or her employment or trade or business. Examples of travel expenses that may qualify for this deduction, depending on the particular circumstances, include the expenses of a trip to France by a teacher of French who is on sabbatical leave from school, and a management professor's tour of foreign businesses.

Traveling costs as deductible charitable contributions

A taxpayer may deduct, as charitable donations, unreimbursed out-of-pocket expenses incurred incident to the rendition of services provided by the taxpayer to a charitable organization (Treas. Reg. sec. 1.170A-1(g)). This rule applies to out-of-pocket transportation expenses, and reasonable expenditures for meals and lodging away from home, if necessarily incurred in performing donated services. No charitable deduction is allowable for the value of the contributed services.

General substantiation requirements

As a general rule, deductions for travel, entertainment, and certain gift expenses are subject to stricter substantiation requirements than most other business deductions (sec. 274(d)). These stricter rules were enacted because Congress recognized that "in many instances deductions are obtained by disguising personal expenses as business expenses."[12]

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[12] H. Rpt. No. 87-1447, 87th Cong., 2d Sess. (1962), at 19.

Under the section 274 rules, the taxpayer must substantiate by adequate records, or sufficient evidence corroborating the taxpayer's statement, the amount of: (1) the expense or item subject to section 274(d); (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. These substantiation rules apply to: (1) traveling expenses (including meals and lodging while away from home); (2) expenditures with respect to entertainment, amusement, or recreation activities or facilities; and (3) business gifts. In addition, the Tax Reform Act of 1984 made additional property subject to the section 274(d) rules, including automobiles used for local travel.[13]

Reasons for Change

In general

Since the 1960's, the Congress has sought to address various aspects of deductions for meals, entertainment, and travel expenses that the Congress and the public have viewed as unfairly benefiting those taxpayers who are able to take advantage of the tax benefit of deductibility. In his 1961 Tax Message, President Kennedy reported that "too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government." He stated: "This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

The committee shares these concerns, and believes that these concerns are not addressed adequately by present law. In general, present law requires some heightened showing of a business purpose for travel and entertainment costs, as well as stricter substantiation requirements than those applying generally to all business deductions. However, the present-law approach fails to address a basic issue inherent in allowing deductions for many travel and entertainment expenditures—the fact that, even if reported accurately and having some connection with the taxpayer's business, such expenditures also convey substantial personal benefits to the recipients.

The committee believes that present law, by not focusing sufficiently on the personal-consumption element of deductible meal and entertainment expenses, unfairly permits taxpayers who can arrange business settings for personal consumption to receive, in effect, a Federal tax subsidy for such consumption that is not available to other taxpayers. The taxpayers who benefit from deductibility under present law tend to have relatively high incomes, and in some cases the consumption may bear only a loose relationship to business necessity. For example, when executives have dinner at an expensive restaurant following business discussions and then

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[13] Pursuant to P.L. 99-44, these additional categories of expenses will become subject to the sec. 274(d) substantiation requirements on January 1, 1986.

deduct the cost of the meal, the fact that there may be some bona fide business connection does not alter the imbalance between the treatment of those persons, who have effectively transferred a portion of the cost of their meal to the Federal Government, and other individuals, who cannot deduct the cost of their meals.

The significance of this imbalance is heightened by the fact that business travel and entertainment often may be more lavish than comparable activities in a nonbusiness setting. For example, meals at expensive restaurants and season tickets for luxury boxes at sporting events are purchased to a significant degree by taxpayers who claim business deductions for these expenses. This disparity is highly visible, and contributes to public perceptions that the tax system is unfair. Polls indicate that the public identifies the deductibility of normal personal expenses such as meals to be one of the most significant elements of disrespect for and dissatisfaction with the present tax system.

In light of these considerations, the committee bill reduces by 20 percent the amount of otherwise allowable deductions for business meals and entertainment. This reduction rule reflects the fact that meals and entertainment inherently involve an element of personal living expenses, but still allows an 80 percent deduction where such expenses also have an identifiable business relationship. The bill also tightens the requirements for establishing a bona fide business reason for claiming meal and entertainment expenses as deductions. The committee provided various exceptions in the bill to the general percentage reduction rule, including exceptions for certain traditional employer-paid recreational expenses for employees, de minimis fringe benefits, promotional activities made available to the general public, and costs for certain sports events related to charitable fundraising.

Required business purpose for meals

In certain respects, more liberal deduction rules are provided under present law with respect to business meals than other entertainment expenses, both as to the underlying legal requirements for deductibility and as to substantiation requirements. The committee believes that more uniform deduction rules should apply. In addition, the committee believes that business meals should be deductible only if the meal has a clear business purpose presently related to the active conduct of the taxpayer's trade or business. In addition, the committee believes that special penalties should apply when taxpayers fraudulently or negligently claim business meal deductions to which they are not entitled.

Skybox rentals

Under present law, taxpayers generally cannot claim deductions or credits for the cost of entertainment facilities, including private luxury boxes ("skyboxes") at sports arenas. However, a taxpayer may be able to circumvent this rule by leasing a skybox instead of purchasing it. Accordingly, the committee bill disallows deductions for the costs of leasing a skybox for more than one event.

Excess ticket costs

In some cases, taxpayers may claim entertainment expense deductions for ticket purchases that exceed the face value of the tickets. For example, a taxpayer may pay an amount in excess of the face price to a "scalper" or ticket agent. The committee believes that deductions for ticket costs in excess of the face value amount generally should not be allowed. However, this limitation does not apply to ticket expenses for sports events meeting certain requirements under the bill relating to charitable fundraising.

Luxury water travel

The committee believes that present law may allow excessive deductions for business travel undertaken by luxury water travel (e.g., by cruise ship). Taxpayers who engage in luxury water travel ostensibly for business purposes may have chosen this means of travel for personal enjoyment over other reasonable alternatives that may better serve business purposes by being faster and less expensive. Also, the costs of cruise ship travel may include elements of entertainment and meals (not separately charged) that are not present in other transportation. Accordingly, the committee bill generally places per diem dollar limitations on deductions for luxury water transportation.

Travel as a form of education

The committee is concerned about deductions claimed for travel as a form of "education." The committee believes that any business purpose served by traveling for general educational purposes, in the absence of a specific need such as engaging in research which can only be performed at a particular facility, is at most indirect and insubstantial. By contrast, travel as a form of education may provide substantial personal benefits by permitting some individuals in particular professions to deduct the cost of a vacation, while most individuals must pay for vacation trips out of after-tax dollars, no matter how educationally stimulating the travel may be. Accordingly, the committee bill disallows deductions for travel that can be claimed only on the ground that the travel itself is "educational", but permits deductions for travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education.

Charitable deductions for travel expenses

The committee is also concerned about charitable deductions claimed by some persons for expenses of travel away from home to vacation sites, etc. Recently, there has been a proliferation of widely publicized programs implying that individuals can travel to appealing locations and claim charitable deductions for their travel and living costs, on the ground that the taxpayers perform services assisting the charities. In many cases, however, the value of the services performed may be minimal compared to the amount deducted. Accordingly, the committee believes that charitable deductions for travel expenses away from home should be denied where the travel involves a significant element of personal recreation or vacation; this same rule applies under present law for travel ex-

penses claimed as medical deductions. However, deductions for such expenses as the out-of-pocket expenditures incurred by a troop leader on a youth group camping trip would be allowed.

Expenses for nonbusiness conventions

The committee is concerned about deductions claimed for travel and other costs of attending conventions or other meetings that relate to financial or tax planning, rather than to a trade or business of the taxpayer. For example, individuals claim deductions for attending seminars about investments in securities or tax shelters. In many cases, these seminars are held in locations (including some that are overseas) that are attractive for vacation purposes, and are structured so as to permit extensive leisure activities on the part of attendees. Since investment purposes do not relate to the taxpayer's means of earning a livelihood (i.e., a trade or business), the committee believes that these abuses, along with the personal consumption issue that arises with respect to any deduction for personal living expenses, justify denial of any deduction for the costs of attending a nonbusiness seminar or similar meeting that does not relate to a trade or business of the taxpayer.

Explanation of Provisions

a. Percentage reduction for meal and entertainment expenses

In general

Under the bill, the amount of an otherwise allowable deduction for a meal or entertainment expense is reduced by 20 percent. For example, if a taxpayer spends $100 for a business meal which, but for this rule, would be fully deductible, the amount of the allowable deduction would be $80.

For purposes of this rule, meals and entertainment activities generally are defined as under present law. Thus, 20 percent of an otherwise allowable deduction for food or beverages, including food or beverage costs incurred in the course of travel away from home, is disallowed. Similarly, the cost of a meal furnished by an employer to employees on the employer's premises is subject to the rule. An entertainment activity is defined, for purposes of this rule, in accordance with section 274(a)(1)(A), i.e., as an activity which is of a type generally considered to constitute entertainment, amusement, or recreation. (See discussion below of certain exceptions to the percentage reduction rule.)

In determining the amount of the otherwise allowable deduction that is subject to reduction under this rule, expenses for taxes and tips relating to a meal or entertainment activity are included. For example, in the case of a business meal for which the taxpayer pays $50, plus $4 in tax and $10 in tips, the amount of the deduction cannot exceed $51.20 (80 percent of $64). Expenses such as cover charges for admission to a night club, the amount paid for a room which the taxpayer rents for a dinner or cocktail party, or the amount paid for parking at a sports arena in order to attend an entertainment event there, likewise are deductible only to the extent of 80 percent under the rule. However, an otherwise allowable deduction for the cost of transportation to and from a business

meal (e.g., cab fare to a restaurant) is not reduced pursuant to the rule.

The percentage reduction rule is applied only after determining the amount of the otherwise allowable deduction under sections 162 and 274. Meal and entertainment expenses first are limited to the extent (if any) required pursuant to other applicable rules set forth in section 162 or section 274, and then are reduced by 20 percent.[14]

For example, if a travel meal costs $100, but, under section 162(a)(2), $40 of that amount is disallowed as "lavish and extravagant," then the remaining $60 is reduced by 20 percent, leaving a deduction of $48. Similarly, when a taxpayer buys a ticket to an entertainment event for more than the ticket's face value, the deduction cannot exceed 80 percent of the face value of the ticket. However, the effect of the percentage disallowance rule is determined prior to application of deduction limits other than those contained in sections 162 and 274 (e.g., the one percent floor on miscellaneous deductions imposed by section 132 of the bill, described above).

Exceptions

The bill provides certain exceptions to the applicability of the percentage reduction rule.

First, the cost of a meal or of an entertainment activity is fully deductible if the full value thereof is taxed as compensation to the recipients (whether or not they are employees) or is excludable under section 132, pursuant to either the subsidized eating facility exclusion or the exclusion for de minimis fringe benefits. For example, a transfer for business purposes of a packaged food or beverage item (e.g., a holiday turkey or ham, fruitcake, or bottle of wine) is not subject to the percentage reduction rule where the de minimis fringe benefit exclusion applies.

Second, in the case of a taxpayer who is reimbursed for the cost of a meal or of entertainment, the percentage reduction rule instead applies to the party making the reimbursement. This exception may apply, for example, in the case of a salesperson who pays for a lunch with a customer at which a sales contract is discussed and then is reimbursed by his or her employer.

Third, the percentage reduction rule does not apply in the case of certain traditional recreational expenses for employees that are paid by employers. For example, this exception may apply in the case of an employer's deduction for reasonable costs of a year-end holiday party or a summer outing for employees and their spouses.

Fourth, the reduction rule does not apply in the case of items, such as samples and promotional activities, that are made available to the general public. For example, if the owner of a hardware store advertises that tickets to a baseball game will be provided to the first 50 people who visit the store on a particular date, or who purchase an item from the store during a sale, then the full amount of the face value of the tickets is deductible by the owner.

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[14] However, in the case of a separately stated meal or entertainment cost incurred in the course of luxury water travel, the percentage disallowance rule is applied prior to application of the limitation on luxury water travel expenses (discussed below).

Similarly, a wine merchant who permits potential customers to sample wine of the type that the merchant is offering for sale may deduct in full the cost of wine used as a sample, along with reasonable costs that are associated with the winetasting (e.g., food that is provided with the wine to demonstrate the suitability of the wine for particular types of meals.)

Fifth, expenses for attendance at a sports event, to the extent otherwise allowable as a business deduction, are not subject to the percentage reduction rule if the event meets certain requirements related to charitable fundraising. In order for such costs to be fully deductible as a business expense under this rule, the event must (1) be organized for the primary purpose of benefiting a tax-exempt charitable organization (described in sec. 501(c)(3)), (2) contribute 100 percent of its net proceeds to charity, and (3) utilize volunteers for substantially all work performed in carrying out the event. This rule applies to the cost of a ticket package, i.e., the amount paid both for seating at the event, and for related services such as parking, use of entertainment areas, contestant positions, and meals furnished at and as part of the event.

For example, a golf tournament that donates all of the net proceeds from the event to charity is eligible to qualify under this exception. Such a tournament would not fail to qualify solely because it offered prize money to golfers who participated, or used paid concessionaires or security personnel. However, the committee intends that tickets to college or high school football or basketball games or other similar scholastic events will not qualify under the exception. Such games generally do not satisfy the requirement that substantially all work be performed by volunteers, if the institutions (or parties acting on their behalf) pay individuals to perform such services as coaching or recruiting.

Finally, the cost of providing meals or entertainment is fully deductible to the extent that it is sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. For example, a restaurant may deduct the full amount of its ordinary and necessary expenses in providing meals to paying customers.

b. Additional requirements relating to meals

The committee bill also makes certain changes in the legal and substantiation requirements applying to deductions for business meals.

First, the bill provides that a meal expense, like other entertainment expenses under present law, is not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business. Under this standard, a business meal expense generally is not deductible unless there is a substantial and bona fide business discussion during, directly preceding, or directly following the meal. However, in the case of an individual who is away from home in the pursuit of a trade or business and who eats alone, the absence of a business discussion does not pre-

clude satisfying the "directly related" or "associated with" requirement.

For purposes of deducting meal expenses, the business discussion requirement (applying to any business meal other than one consumed alone by an individual who is away from home in the pursuit of a trade or business) is deemed not to have been met if neither the taxpayer nor any employee of the taxpayer is present at the meal. Thus, for example, if the taxpayer reserves a table at a business dinner but neither the taxpayer nor an employee of the taxpayer attends the dinner, no deduction will be allowed. Similarly, if one party to a contract negotiation buys dinner for other parties involved in the negotiations, but does not attend the dinner, the deduction is denied even if the other parties engage in a business discussion.[15]

For purposes of this rule, an independent contractor who renders significant services to the taxpayer (other than attending meals on the taxpayer's behalf, or providing services relating to meals) is treated as an employee, if he or she attends the meal in connection with such performance of services. Thus, for example, an atttorney who was retained by a taxpayer to represent the taxpayer in a particular legal proceeding would be treated as an employee of the taxpayer for purposes of this rule, if the attorney represented the taxpayer at a business meal at which the legal proceeding was discussed.

Second, the bill provides that the cost of a business meal is not deductible unless the meal has a clear business purpose presently related to the active conduct of a trade or business. This requirement is stricter than the generally applicable requirement for deducting meal and entertainment expenses (described above). Thus, the clear business purpose requirement is not satisfied in the case of a meal at which the business discussion does not concern a specific business transaction or arrangement. In addition, the cost of a meal is not deductible if it serves non-trade or business purposes of the taxpayer (e.g., investment purposes) rather than trade or business purposes and thus under present law would give rise to a deduction (if at all) under section 212 rather than section 162.

Third, the bill makes explicit that the statutory rule under present law disallowing deductions for certain lavish and extravagant travel expenses (including for meals) applies to all business meals. Thus, it applies whether or not the expense is incurred while the taxpayer is away from home, and whether or not the taxpayer incurs the expense alone or with others.

Finally, under the bill, to the extent that a taxpayer claims business meal deductions to which the taxpayer is not legally entitled, a special penalty rule applies if the error is negligent or fraudulent. If the erroneous deduction was due to negligence or disregard of rules and regulations, the otherwise applicable negligence penalty will not be less than 50 percent of the underpayment resulting from the improperly claimed deduction. If the error is due to fraud, the penalty equals 100 percent of the extra amount of tax due.

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[15] However, the requirement that the taxpayer be present does not apply in the case of a transfer for business purposes of a packaged food or beverage item, such as a holiday turkey, ham, fruitcake, or bottle of wine.

The rules of the bill reflect the committee's concerns about deductions claimed for meals that do not clearly serve business purposes or are not adequately substantiated. In keeping with these concerns, the committee expects the Treasury to adopt regulations providing, to the extent reasonable, stricter substantiation requirements for business meal deductions. For example, such regulations could relate to the need for documentary evidence, such as a restaurant receipt, substantiating business meal expenses, including expenses of less than $25 per day. The committee also emphasizes that, under present law, as well as under the bill, courts may not apply the so-called "Cohan rule," allowing approximation of the amount of an expense, to any business meal or other entertainment expense.

c. Deductions for tickets limited to face value

Under the bill, a deduction (if otherwise allowable) for the cost of a ticket for an entertainment activity is limited (prior to application of the 20 percent reduction rule) to the face value of the ticket. The face value of a ticket includes any amount of ticket tax on the ticket. Under this rule, for example, a payment to a "scalper" for a ticket is not deductible (even if not disallowed under present law as an illegal payment) to the extent that the amount paid exceeds the face value of the ticket. Similarly, a payment to a ticket agency for a ticket is not deductible to the extent in excess of the face value of the ticket.

However, the face value limitation does not apply to an expense that is excepted under the bill from the percentage reduction rule because it relates to a sports event that meets certain requirements related to charitable fundraising (see description above).

d. Disallowance of deductions for certain "skybox" rentals

The bill also generally disallows deductions relating to rental or similar payments for use of a "skybox." The latter term means any private luxury box or other facility at a sports arena that is separated from other seating, and is available at a higher price (counting all applicable expenses, e.g., rental of the facility, as well as separate charges for food and seating) than the price generally applicable to other seating.

The disallowance rule does not apply unless the taxpayer (or a related party, including one engaged in a reciprocal rental arrangement with the taxpayer) rents a skybox at the same sports arena for more than one event. For purposes of this rule, a single game or other performance counts as one event. Thus, for example, a taxpayer who rents a skybox for two World Series games in the same stadium is treated as renting a skybox for two events. The deductibility of a single-event rental is determined under the rules generally applicable to entertainment activities.

In determining whether a taxpayer has rented a skybox for more than one event, all skybox rentals by the taxpayer in the same arena, along with any related rentals, are considered together. For example, rentals of different skyboxes in the same stadium, or rentals by the same taxpayer pursuant to separate rental agreements, constitute related rentals. In addition, rentals by related parties are considered related rentals. For example, this rule ap-

plies where members of the same family, corporations with common ownership, or taxpayers who have made a reciprocal arrangement involving sharing skyboxes, respectively lease skyboxes for different events.

If the disallowance rule applies, two types of expenses related to the skybox still may be deductible. First, the deductibility of separately stated charges for food or beverages is determined under the rules generally applying to business meals (described above), including the percentage reduction rule. Second, an amount not exceeding the face values of non-luxury box seat tickets for the number of seats in the luxury box may be deducted (subject, however, to further reduction under the percentage reduction rule).

For example, in a stadium where box seats (other than in luxury boxes) are sold for between $8 and $12, a taxpayer subject to the skybox disallowance rule may treat the deductible amount as equal to $12 multiplied by the number of seats in the luxury box. This method applies whether or not the luxury box is fully occupied during an event, and without regard to whether amounts paid for the luxury box nominally constitute payments for the seats, or rentals for the luxury box. However, in determining the amount charged for non-luxury box seats, only prices charged for a genuine category of such seats are taken into account. Consider, for example, the case of a sports arena which, in order to increase the deductions allowable with respect to skyboxes, reserved a small group of seats for which it charged $50 even though those seats were not significantly better than the seats which it offered for $12. In such a case, the $50 price would be disregarded as not bona fide.

e. Travel as a form of education

Under the bill, no deduction is allowed for travel as a form of education. This rule applies when a travel deduction would otherwise be allowable only on the ground that the travel itself serves educational purposes (for example, in the case of a teacher of French who travels to France in order to maintain general familiarity with the French language and culture). This disallowance rule does not apply when a deduction is claimed with respect to travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education (for example, where a scholar of French literature travels to Paris in order to do specific library research that cannot be done elsewhere, or to take courses that are offered only at the Sorbonne, in circumstances such that the nontravel research or course costs are deductible).

f. Charitable deductions for travel expenses

The bill places limitations on charitable deductions for the cost of travel away from home. Under this rule, no charitable deduction is allowed for transportation and other traveling expenses (including costs for meals and lodging) incurred in performing services away from home for a charitable organization unless there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. The same limitation applies as under present law with respect to medical deductions for lodging costs away from home (sec. 213(d)(2)(b)).

This rule applies only with respect to expenses relating to travel by the taxpayer or by a person associated with the taxpayer (e.g., a family member). The rule does not apply to the extent that the taxpayer pays for travel by third parties who are participants in the charitable activity (for example, expenses for travel by children unrelated to the taxpayer, personally incurred by the troop leader for a tax-exempt youth group who takes children belonging to the group on a camping trip). However, the disallowance rule applies in the case of any reciprocal arrangement (e.g., when two unrelated taxpayers pay each other's travel expenses, or members of a group contribute to a fund that pays for all of their travel expenses).

The disallowance rule applies whether the travel expenses are paid directly by the taxpayer, or indirectly through reimbursement by the charitable organization. For this purpose, any arrangement whereby a taxpayer makes a payment to a charitable organization and the organization pays for his or her travel expenses is treated as a reimbursement.

In determining whether travel away from home involves a significant element of personal pleasure, recreation, or vacation, the fact that a taxpayer enjoys providing services to the charitable organization will not lead to denial of the deduction. For example, a troop leader for a tax-exempt youth group who takes children belonging to the group on a camping trip may qualify for a charitable deduction with respect to his or her own travel expenses if he or she is on duty in a genuine and substantial sense throughout the trip, even if he or she enjoys the trip or enjoys supervising children. By contrast, a taxpayer who only has nominal duties relating to the performance of services for the charity, or who for significant portions of the trip is not required to render services, is not allowed any charitable deduction for travel costs.

The disallowance rule in the bill has no effect on deductions other than charitable deductions that may be claimed with respect to travel on behalf of a charitable organization. For example, the rule does not affect the deductibility under section 162 of an employee business expense incurred by an employee of a charitable organization.

g. Expenses for nonbusiness conventions, etc.

Under the bill, no deduction is allowed for expenses related to attending a convention, seminar, or similar meeting unless such expenses are deductible under section 162 as ordinary and necessary expenses of carrying on a trade or business. Thus, the bill disallows deductions for expenses of attending a convention, etc. where the expenses, but for the provision in the bill, would be deductible under section 212 (relating to expenses of producing income) rather than section 162. The expenses to which the provision relates typically include such items as travel to the site of such a convention, fees for attending the convention, and personal living expenses, such as meals, lodging, and local travel, that are incurred while attending the convention or other meeting.

h. Luxury water travel

The bill also places limitations on allowable deductions for travel by ocean liner, cruise ship, or other form of luxury water transpor-

tation. This rule applies, for example, in the case of a taxpayer who has business reasons for traveling from New York City to London and who travels by ocean liner.

Under the bill, the deduction allowable in the case of luxury water travel cannot exceed twice the highest amount generally allowable with respect to a day of travel to employees of the executive branch of the Federal Government while away from home but serving in the United States, multiplied by the number of days the taxpayer was engaged in luxury water travel. For example, if during a particular taxable year the applicable Federal per diem amount is $75, a taxpayer's deduction for a six-day trip cannot exceed $900 ($150 per day times six days). The applicable per diem amount generally is the highest travel amount applying for an area in the conterminous United States; however, any limited special exception to this amount (e.g., a higher limit that applied only to high-ranking executive personnel) would be disregarded.

If the expenses of luxury water travel include separately stated amounts for meals or entertainment, the amounts so separately stated are reduced by 20 percent, under the percentage reduction rule, prior to application of this per diem limitation. However, in the absence of separately stated meal or entertainment charges, taxpayers are not required to allocate a portion of the total amount charged to meals or entertainment unless the amounts to be allocated are clearly identifiable.

The per diem rule does not apply in the case of any expense allocable to a convention, seminar, or other meeting which is held on any cruise ship. Thus, the per diem rule does not alter the application of the present-law rule under which deductions for conventions held abroad cruise ships are wholly denied or, in certain special cases, allowed to the extent not in excess of $2,000 per individual. Also, it is intended under the bill that the statutory exceptions to the business meal percentage reduction rule (described above) are also exceptions to the per diem rule with respect to luxury water travel.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $1,258 million in 1986, $2,027 million in 1987, $2,121 million in 1988, $2,364 million in 1989, and $2,552 million in 1990.

3. Changes in Treatment of Hobby Losses (Secs. 143(a) and 143(b) of the bill and sec. 183 of the Code)

Present Law

Expenses arising from hobbies (i.e., activities not engaged in for profit) are allowed only as itemized deductions. Except for expenses that are deductible without reference to whether they are incurred in an activity designed to produce income (i.e., certain interest and taxes), hobby expenses are deductible only to the extent not exceed-

ing the amount of hobby income for the year (Code sec. 183). These rules apply, for example, to activities such as horse-breeding, farming, and researching a restaurant or travel guide, if the taxpayer's motivations are recreational rather than profit-oriented.

A facts and circumstances test generally applies to determine whether a particular activity constitutes a hobby. However, statutory rules provide that if the gross income from an activity exceeds the deductions attributable thereto for two or more out of five consecutive years (seven consecutive years in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses), then the activity is presumed to be engaged in for profit rather than as a hobby. The presumption that an activity is not a hobby if it is profitable in two out of five consecutive years (or seven consecutive years, for certain activities) can be overcome by the Internal Revenue Service under the general facts and circumstances test.

Reasons for Change

The committee is concerned that the statutory presumption under present law regarding whether an activity is being engaged in for profit may unduly benefit some taxpayers who engage in activities as hobbies, but who can structure their earnings and expenses so as to realize a profit in at least two out of five consecutive years. For example, the presumption can apply even if the taxpayer realizes a substantial net loss over five years that reflects a willingness to incur losses as the cost of personal recreation, rather than unexpected business difficulties. Even though the Internal Revenue Service can overcome the statutory presumption, some abuse nonetheless may arise, in light of the subjective nature of a general facts and circumstances test. However, in the case of horse breeding, training, showing, and racing activities, the committee believes that the present-law rules should continue to apply.

Explanation of Provision

Under the bill, for activities other than those consisting in major part of horse breeding, training, showing, or racing, the statutory presumption of being engaged in for profit applies only if the activity is profitable in three out of five consecutive years. The rules governing the tax treatment of hobby losses are not changed by the provision in any other respect.

As in the case of other expenses deductible as miscellaneous itemized deductions, deductible hobby expenses—other than costs that are deductible without reference to whether they are incurred in an activity designed to produce income (such as certain interest and taxes)—are subject to section 132 of the bill, establishing a one-percent floor under miscellaneous itemized deductions.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

4. Changes in Deduction for Business Use of Home (Sec. 143(c) of the bill and sec. 280A of the Code)

Present Law

Requirements for deduction

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., rent, depreciation, and repairs). However, no deduction is allowed unless the taxpayer uses part of the home regularly and exclusively either as the principal place of business of the taxpayer or to meet patients, clients, or customers (Code sec. 280A). In addition, a deduction may be permissible if the part of the home used for business purposes constitutes a separate structure. For an employee, a further requirement for a deduction is that the business use of the home must be for the convenience of the employer.

These general business-use requirements need not be met in the case of rental use of a part of the home (e.g., when the taxpayer rents a room to a lodger). In a recent Tax Court case, *Feldman* v. *Commissioner*, 84 T.C. 1 (1985), this rental exception was applied, and the general requirements for the deduction held inapplicable, where an employer nominally rented a portion of the employee's home used by the employee in performing services for the employer. The court permitted the taxpayer to deduct home office expenses without requiring regular and exclusive use of the home either as the taxpayer's principal place of business or as a place to meet patients, clients, or customers, notwithstanding the court's finding that the rental was not an arm's length arrangement and was made for more than the fair rental value of the space that nominally was rented.

Limitations on deduction

Deductions for home office costs that are allowed solely because there is a qualifying business use of the home are limited to the amount of the taxpayer's gross income derived from the business use of the home during the taxable year. Costs in excess of the limitation cannot be carried over and used as deductions in other taxable years. This limitation has no effect on deductions (such as home mortgage interest and real property taxes) that are allowable in the absence of business use.

The Internal Revenue Service has issued proposed regulations defining gross income derived from the business use of the home as gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself, such as expenditures for supplies and compensation paid to other persons.[16] However, in *Scott* v. *Commissioner*, 84 T.C.

[16] Proposed Treas. Reg. sec. 1.280A-2(i)(2)(iii), 48 Fed. Reg. 33325 (July 21, 1983).

683 (1985), the Tax Court rejected this interpretation, holding that gross income from the use of the home means gross income from the business activity itself, i.e., not reduced by any outside expenditures required for the activity.

Under the Tax Court's interpretation, deductions for business use of one's home could be used to create or increase a net loss from the activity and thus, in effect, to offset income from unrelated activities. For example, assume that a taxpayer derived gross income of $1,000 from an activity, and incurred expenses of $1,500 that related to the activity but that did not relate to use of the home (e.g., expenses for supplies, secretaries, and messengers). Under the Tax Court's interpretation, the taxpayer would be permitted to deduct up to $1,000 in home office costs that are not otherwise deductible (e.g., rent or depreciation), despite the fact that there was no net income from the activity.

Reasons for Change

Requirements for deduction

The committee believes that taxpayers should not be able to circumvent the limitations on home office deductions by arranging for their employers to rent portions of their homes. The allowance of such arrangements would significantly narrow the applicability of section 280A and could encourage tax avoidance of the sort that that section was intended to prevent.

Section 280A was enacted due to concern that some taxpayers were converting nondeductible personal and living expenses into deductible business expenses simply because they found it convenient to perform some work at home.[17] The committee recognizes that in some instances a legitimate cost resulting from business use of a home could conceivably be disallowed under the restrictions of section 280A; however, any such instances would be difficult to identify and define. Further, the committee believes that allowing deductions for use of a taxpayer's residence inherently involves the potential for abuse. In enacting section 280A, the Congress concluded that absent limitations, taxpayers could claim home office deductions even when no marginal cost of maintaining the home was incurred by the taxpayer as a result of the business use. Thus, the Congress concluded that home office deductions should be disallowed in the absence of specified circumstances indicating a compelling reason for business use of the home, and in any event should not be permitted to offset taxable income derived from unrelated activities.

Under the interpretation of section 280A applied by the Tax Court in *Feldman*, the committee believes the statute would fail to achieve its intended purpose. Allowing employees to use lease arrangements with employers as a method of circumventing the restrictions on home office deductions might encourage some taxpayers to arrange sham transactions whereby a portion of salary is paid in the form of rent. Moreover, it is questionable whether lease transactions between an employer and employee are generally ne-

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[17] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (H.R. 10612, 94th Cong., Public Law 94-455), at 139.

gotiated at arm's length, particularly if such a transaction could provide added tax deductions to the employee at no additional cost to the employer. Accordingly, the committee believes that no home office deductions should be allowable (except for expenses such as home mortgage interest and real property taxes that are deductible absent business use) if the employee rents a portion of his or her home to the employer.

Limitations on deduction

In general.—The *Scott* decision would permit taxpayers to use home office deductions to create or increase a net loss from the business activity, and thus to offset unrelated income. The committee believes that a home office deduction to which section 280A applies should not be used to reduce taxable income from the activity to less than zero. In adopting the provisions of the bill, the committee reemphasizes that section 280A was enacted because of concerns about allowing deductions for items which have a substantial personal component relating to the home, which most taxpayers cannot deduct, and which frequently do not reflect the incurring of significantly increased costs as a result of the business activity, and that the provision should be interpreted to carry out its objectives.

Carryover.—Finally, the committee believes that the application of section 280A under present law may be unduly harsh in one respect. Deductions that are disallowed because they exceed the statutory limitation (i.e., the amount of income from the business activity) cannot be carried forward to subsequent taxable years and claimed to the extent of subsequent income from the activity. However, since the purpose of this limitation is to deny the use of home office deductions to offset unrelated income, the committee believes that deduction carryforwards should be allowed, subject to the general limitation that the home office deductions in any year cannot create or increase a net loss from the business activity.

Explanation of Provision

Requirements for deduction

The bill provides that no home office deduction is allowable by reason of business use where the taxpayer leases a portion of his or her home to an employer. For this purpose, an individual who is an independent contractor is treated as an employee, and the party for whom such individual is performing services is treated as an employer. In the case of a lease that is subject to this rule, no home office deductions are allowed except to the extent that they would be allowable in the absence of any business use (e.g., home mortgage interest expense and real property taxes).

Limitations on deduction

In general.—The bill limits the amount of a home office deduction (other than expenses that are deductible without regard to business use, such as home mortgage interest) to the taxpayer's gross income from the activity, reduced by all other deductible expenses attributable to the activity but not allocable to the use of the unit itself. Thus, home office deductions are not allowed to the

extent that they create or increase a net loss from the business activity to which they relate.

Carryover.—The bill provides a carryforward for those home office deductions that are disallowed solely due to the income limitation on the amount of an otherwise allowable home office deduction. Deductions that meet the general requirements of section 280A but that are disallowed solely because of the income limitation may be carried forward to subsequent taxable years, subject to the continuing application of the income limitation to prevent the use of such deductions to create or increase a net loss in any year from the business activity.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

5. Deductibility of Mortgage Interest and Taxes Allocable to Tax-Free Allowances for Ministers and Military Personnel (Sec. 144 of the bill and sec. 265 of the Code)

Present Law

Code section 265(1) disallows deductions for expenses allocable to tax-exempt income. That provision has most frequently been applied to disallow a deduction for expenses incurred in the production of tax-exempt income (e.g., expenses incurred in earning income on tax-exempt investments). However, the provision has also been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction.

In January 1983, the Internal Revenue Service ruled that section 265(1) precludes a minister from taking deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to a tax-free housing allowance (under sec. 107) received by the minister (Rev. Rul. 83-3, 1983-1 C.B. 72). This ruling revoked a 1962 ruling which had taken a contrary position. In its 1983 ruling, the Revenue Service stated that where a taxpayer incurs expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265(1) as interpreted by the courts.

The 1983 ruling generally was made applicable beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule was delayed with respect to such home until January 1, 1985, by IRS Ann. 83-100; until January 1, 1986, by P.L. 98-369; and until January 1, 1987, by Rev. Rul. 85-96.

Reasons for Change

The committee believes that the exclusions for housing allowances of ministers or military personnel are intended to provide a tax benefit to such individuals that should not be limited by disallowing deductions for mortgage interest or taxes attributable to their residence.

Explanation of Provision

The bill provides that the receipt of a parsonage housing allowance (sec. 107) or a military housing allowance is not to result in a denial under section 265 of deductions for mortgage interest or real property tax deductions on the taxpayer's home. This provision thus overrules Rev. Rul. 83-3 as applicable to parsonage allowances (but not in other respects) and precludes application of that ruling to military housing allowances.

Effective Date

The provision applies to taxable years beginning before, on, or after December 31, 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

TITLE II—CAPITAL INCOME PROVISIONS

A. Cost Recovery Provisions: Depreciation and the Regular Investment Tax Credit (secs. 201, 202, 203, and 211 of the bill and secs. 38, 46, 57, 168, 179, 312(k), 1250, and new sec. 49 of the Code)

Present Law

Overview

The Economic Recovery Tax Act of 1981 ("ERTA") enacted the Accelerated Cost Recovery System ("ACRS") for tangible depreciable property placed in service after 1980. Under ACRS, the cost or other basis of eligible property (without reduction for salvage value) is recovered using an accelerated method of depreciation over a predetermined recovery period that is generally shorter than, and otherwise unrelated to, the asset's useful life (sec. 168). Under prior law, an asset's cost (less salvage value) was recovered over its estimated useful life (sec. 167). Prior law rules remain in effect for property placed in service by a taxpayer before 1981, and for property not eligible for ACRS.

ACRS

Under ACRS, the allowable recovery deduction in each recovery year is determined by applying a statutory percentage to the property's original cost (adjusted, as described below, for investment tax credit allowed) (sec. 168(b)(1)).

Personal property

The statutory percentages for personal property are based on the 150-percent declining balance method for the early recovery years, switching to the straight-line method at a time to maximize the recovery allowance. Alternatively, taxpayers can elect to use the straight-line method over the applicable ACRS recovery period (or over a longer recovery period) with respect to one or more classes of ACRS property placed in service during a taxable year (sec. 168(b)(3)(A)). Under a "half-year" convention, the statutory tables and straight-line alternatives provide a half-year recovery allowance for the first recovery year, whether the property is placed in service early or late in the year. No recovery allowance is allowed in the taxable year in which the taxpayer disposes of the asset.

The cost of eligible personal property is recovered over a three-year, five-year, 10-year, or 15-year recovery period, depending on the recovery class of the property.

Property with an ADR midpoint life of four years or less (such as automobiles, light general purpose trucks, certain special tools, and over-the-road tractor units), racehorses more than two years old when placed in service and other horses more than 12 years old

when placed in service, and property used in connection with research and experimentation are included in the three-year class. The 10-year class includes long-lived public utility property with an ADR midpoint life from 18.5 to 25 years, certain burners and boilers; and railroad tank cars. Longer-lived public utility property having an ADR midpoint life over 25 years is in the 15-year class. Most other personal property is assigned to the five-year class. The ADR midpoint lives used to assign assets to ACRS classes and for other purposes were initially established by the Treasury Department in 1971 and have been modified several times since then.

Taxpayers are required to reduce the basis of assets by 50 percent of the amount of regular or energy investment tax credits allowed with respect to personal property (and the reduced basis is used to compute recovery deductions) (sec. 48(q)(1)). With respect to the regular investment tax credit, a taxpayer can elect a 2-percentage point reduction in the credit in lieu of the half-basis adjustment (sec. 48(q)(4)).

Real property

The statutory percentages for real property are based on the 175-percent declining balance method (200-percent for low-income housing described in section 1250(a)(1)(B)(i)-(iv)), switching to the straight-line method at a time to maximize the deduction (sec. 168(b)(2) and (4)). For the year of acquisition and disposition of real property, the recovery allowances are based on the number of months during those years that the property is in service. Under a "mid-month" convention, real property (other than low-income housing) placed in service or disposed of by a taxpayer at any time during a month is treated as having been placed in service or disposed of in the middle of the month.

For real property placed in service after May 8, 1985, the cost of real property is recovered over a 19-year recovery period (15 years for low-income housing), although longer recovery periods may be elected (sec. 168(b)(2) and (4)).

Generally, low-income housing includes projects eligible for various Federal, State, and local housing programs and projects where 85 percent of the tenants are eligible for, but do not necessarily receive, subsidies under Section 8 of the Housing Act of 1937.

Under ACRS, component cost recovery is not permitted. Thus, the same recovery period and method must be used for the building as a whole, including all structural components. A substantial improvement (generally, one that is made over a two-year period at a cost that is at least 25 percent of a building's unadjusted basis) is treated as a separate building, the cost of which must be separately recovered when the improvement is placed in service.

If the 15-percent or 20-percent investment tax credit for rehabilitation expenditures is allowed, the basis of real property is reduced by the amount of credit earned (and the reduced basis is used to compute recovery deductions) (sec. 48(q)(1) and (3)). The basis of real property is reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of a certified historic structure (sec. 48(q)(1)). In addition, if a credit for rehabilitation expenditures is allowed, the straight-line method of cost recovery must be used with respect to the rehabilitation expenditures.

Recapture

With certain limited exceptions, gain from the disposition of depreciable property is "recaptured" as ordinary income to the extent of previously allowed ACRS deductions (sec. 1245). For residential real property that is held for more than one year, gain is treated as ordinary income only to the extent the depreciation deductions allowed under the prescribed accelerated method exceed the deductions that would have been allowed under the straight-line method (sec. 1250(b)(1)). In addition, recapture for qualified low-income housing is phased out after such property has been held for a prescribed number of months, at the rate of one percentage point per month (sec. 1250(a)(1)(B)). For nonresidential real property held for more than one year, there is no recapture if the taxpayer elected to recover the property's cost using the straight-line method over the applicable ACRS recovery periods (sec. 1245(a)(5)(C)). If accelerated depreciation is claimed with respect to nonresidential real property, the full amount of the depreciation deductions previously taken (to the extent of the gain) is recaptured. Because the benefits of capital gains treatment on gains attributable to previously claimed depreciation often exceed the additional benefit derived from accelerated depreciation, investors frequently choose to claim straight-line depreciation on nonresidential real property.

Application of different depreciation methods for certain purposes

In general, ACRS recovery allowances are reduced for property that is (1) used predominantly outside the United States ("foreign-use property") (sec. 168(f)(2)), (2) leased to a tax-exempt entity, including a foreign person, unless more than 50 percent of the gross income derived from the property is subject to U.S. tax ("tax-exempt use property") (sec. 168(j)), or (3) financed with industrial development bonds the interest on which is exempt from taxation (sec. 168(f)(12)).

Different depreciation methods are also used for purposes of computing earnings and profits of a domestic corporation and applying the minimum tax provisions.

Foreign-use property.—The rationale for reducing ACRS deductions for foreign-use property is that the investment incentive is intended to encourage capital investment in the United States and should not be available to property used predominantly outside the United States. The recovery period for foreign-use personal property is equal to the asset's ADR midpoint life (or 12 years for property without a midpoint life), and the 200-percent declining balance method may be used. The recovery period for foreign-use real property is 35 years, and the 150-percent declining balance method may be used. A taxpayer may elect to use the straight-line method over the applicable recovery period or certain longer periods.

Communications satellites, as defined in Code section 48(a)(2)(B), are excluded from the definition of foreign-use property. Other spacecraft (and interests therein) are not specifically excluded from the definition of foreign-use property.

Tax-exempt use property.—The policy underlying the restriction on tax-exempt use property is to provide tax-reducing incentives

only to those who are subject to income tax, and to deny them to tax-exempt entities, including foreign entities.

Depreciation deductions for tax-exempt use property are computed using the straight-line method and disregarding salvage value. The cost of tax-exempt use personal property is generally recovered over the longer of the asset's ADR midpoint life (12 years if the property has no ADR midpoint life) or 125 percent of the lease term. However, the recovery period for qualified technological property subject to these rules is five years. The recovery period for tax-exempt use real property is the longer of 40 years or 125 percent of the lease term. A taxpayer may elect to recover the cost of tax-exempt use property over an optional extended recovery period. The rules for tax-exempt use property override the rules relating to foreign-use property.

Property financed with industrial development bonds.—Except in the case of property that is placed in service in connection with projects for residential rental property, the cost of property that is financed with tax-exempt industrial development bonds is recovered using the straight-line method over either the applicable ACRS recovery period or optional extended recovery period (sec. 168(f)(12)).

Computation of earnings and profits.—If accelerated incentive depreciation were to apply for purposes of computing earnings and profits, the acceleration of depreciation deductions would reduce a corporation's earnings and profits, and thereby facilitate the distribution of tax-free dividends. For this reason, domestic corporations are required to compute earnings and profits using the straight-line method over recovery periods that are longer than the standard ACRS recovery periods (sec. 312(k)(3)).

The extended recovery periods used to compute earnings and profits are: (1) five years for three-year property, (2) 12 years for five-year property, (3) 25 years for 10-year property, (4) 35 years for 15-year public utility property, and (5) 40 years for 19-year real property and low-income housing.

Minimum taxes.—The minimum tax provisions are designed to prevent taxpayers with substantial economic income from avoiding tax liability by using certain exclusions, deductions, and credits (referred to as "items of tax preference"). In applicable cases, the excess of ACRS deductions over depreciation deductions that would have been allowed had the taxpayer used the straight-line method over a prescribed recovery period is treated as an item of tax preference. For purposes of this rule, the prescribed recovery periods are: (1) five years for three-year property, (2) eight years for five-year property, (3) 15 years for 10-year property, (4) 22 years for 15-year public utility property, (5) 15 years for low-income housing, and (6) 19 years for real property other than low-income housing. These rules apply only with respect to personal property subject to a lease and 19-year real property and low-income housing (sec. 57(a)(12)). Further, personal property subject to a lease is not taken into account for corporations other than personal holding companies (as defined in sec. 542).

Luxury automobiles and mixed-use property.—ACRS deductions are subject to fixed limitations for automobiles and are reduced for certain property (including automobiles) that is used for both per-

sonal and business purposes (sec. 280F). For luxury automobiles, depreciation deductions are limited to $3,200 for the first year in the recovery period, and $4,800 for each succeeding year. For mixed-use property that is used 50 percent or more for personal purposes, capital costs are recovered using the straight-line method of depreciation over the same recovery periods that are used for purposes of computing the earnings and profits of a domestic corporation. ACRS is available for mixed-use property that is used more than 50 percent for business purposes, but only with respect to the portion of the property's basis that is attributable to business use.

Lessee-leasehold improvements

In general, if a lessee makes improvements to property, the lessee is entitled to recover the cost of the improvement over the shorter of the ACRS recovery period applicable to the property or the portion of the term of the lease remaining on the date the property is acquired (sec. 178). If the remaining lease term is shorter than the recovery period, the cost is amortized over the remaining term of the lease. For purposes of these rules, if the remaining term of a lease is less than 60 percent of the improvement's ACRS recovery period, the term of a lease is treated as including any period for which the lease may be renewed pursuant to an option exercisable by the lessee, unless the lessee establishes that it is more probable that the lease will not be renewed (sec. 178(a)). In any case, a renewal period must be taken into account if there is a reasonable certainty the lease will be renewed (sec. 178(c)).

Public utility property

In general, a regulatory commission allows a public utility to charge customers rates that are sufficient to recover the utility's cost of service. A public utility's cost of service includes its annual operating expense and the capital expense allocable to a year. The capital expense that can be passed through as higher prices to customers consists of an annual depreciation charge for equipment and also a rate of return on the capital invested in the equipment and other property (which capital is referred to as the "rate base").

ACRS distinguishes between long-lived public utility equipment and other equipment. Further, as described below, public utilities are required to use a "normalization" method of accounting for ACRS deductions (sec. 168(e)(3)).

Definition of public utility property.—In general, public utility property is property used predominantly in the trade or business of furnishing or selling:

(1) electrical energy, water, or sewage disposal services;

(2) gas or steam through a local distribution system;

(3) telephone services;

(4) other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.C.C. sec. 701); or

(5) transportation of gas or steam by pipeline,

if the rates are established or approved by certain regulatory bodies (secs. 168(e)(3)(A) and 167(l)(3)(A)).

Normalization accounting.—A public utility can use ACRS only if a "normalization" method of accounting is used for purposes of establishing the utility's cost of service and reflecting operating results in its regulated books of account. Normalization requires that (1) a utility's tax expense for ratemaking purposes must be computed as if the depreciation deduction were computed in the same manner as the ratemaking allowance for depreciation (which is generally based on the straight-line method over relatively long useful lives), (2) the deferred taxes (i.e., the difference between the actual tax expense computed using ACRS and that computed for ratemaking purposes) must be reflected in a reserve (and thus be available for capital investment), and (3) the regulatory commission may not exclude from the rate base an amount that is greater than the amount of the reserve for the period used in determining the tax expense as part of the utility's cost of service (see Treas. reg. sec. 1.167(l)-1, which interprets a similar provision of prior law).

Normalization prevents the immediate lowering of rates charged to customers as a result of the cost savings from ACRS. Rather, current tax reductions are flowed through to customers over the period of tax deferral.

Expensing of up to $5,000 of personal property

A taxpayer (other than a trust or estate) can elect to deduct the cost of up to $5,000 of qualifying personal property in the year the property is placed in service, in lieu of recovering the cost under ACRS (sec. 179). In general, qualifying property must be acquired by purchase for use in a trade or business, and must be eligible for the investment tax credit (although no investment credit is allowed for the portion of the cost expensed under this rule). The $5,000 limit is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989.

Regular investment tax credit

General rule

A credit against income tax liability is allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally, not including buildings or their structural components) (secs. 38 and 46). The amount of the regular investment credit is based on the ACRS recovery class to which the property is assigned. The 10-percent credit is allowed for eligible property in the five-year, 10-year, or 15-year public utility property class. Three-year ACRS property is eligible for a six-percent regular credit (even if the taxpayer elects to use a longer recovery period). The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment credit is $125,000 per year; the limitation on used property is scheduled to increase to $150,000 for taxable years beginning after 1987.

Generally, the investment credit is claimed for the taxable year in which qualifying property is placed in service. However, in certain cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of qualified progress expenditures ("QPEs") made during the period of construction before the property is com-

pleted and placed in service. Investment credits claimed on QPEs are subject to recapture if the property fails to qualify for for the investment credit when placed in service.

The amount of income tax liability that can be reduced by investment tax credits in any year is limited to $25,000 plus 85 percent of the liability in excess of $25,000 (sec. 38(c)). Unused credits for a taxable year can be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years (sec. 39).

Public utility property

Public utility property is eligible for the regular investment credit only if the tax benefits of the credit are normalized in setting rates charged by the utility to customers and in reflecting operating results in regulated books of account (sec. 46(f)). The investment credit is denied for public utility property if the regulatory commission's treatment of the credit results in benefits being flowed through to customers more rapidly than under either (1) the ratable flow-through method or (2) the rate base reduction method.

Under the ratable flow-through method (sec. 46(f)(2)), utilities pass through to customers a pro rata portion of the credit during each year of the useful life of the asset. The regulatory commission may not require that the utility reduce its rate base by the amount of the credit. Therefore, even though the credit itself is flowed through to customers over the life of the asset, the utility's shareholders are allowed to earn a return on that amount of the cost of the equipment which has, in effect, been supplied by the Federal government through the regular investment credit.

Under the rate base reduction method (sec. 46(f)(1)), the utility's rate base is reduced by the amount of the credit, so that the shareholders are prevented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. Under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

Finance leases

Overview

The law contains rules to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is entitled to claim tax benefits including cost recovery deductions and investment tax credits with respect to the property. These rules attempt to distinguish between true leases, in which the lessor owns the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owns the property for tax purposes. These rules generally are not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law is that the economic substance of

a transaction, not its form, determines who is the owner of property for tax purposes. Thus, if a transaction is, in substance, simply a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under these rules, lease transactions cannot be used solely for the purpose of transferring tax benefits. They have to have nontax economic substance.

Finance lease provisions

The Tax Equity and Fiscal Responsibility Act of 1982 provided rules (finance leasing rules) that liberalized the leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee has an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor or (2) the property is limited use property is not taken into account in determining whether the agreement is a lease.

A qualified agreement must be a lease determined without taking into account the fact that it contains a 10-percent fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits. The lessor must reasonably expect to derive a profit independent of tax benefits. In addition, the transaction, without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property, must not otherwise be considered a financing arrangement or conditional sale.

The finance lease rules were to have been generally effective for agreements entered into after December 31, 1983, with three temporary restrictions intended to limit the tax benefits of finance leasing in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 was to qualify for finance lease treatment. Second, a lessor could not have used finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap was to apply to property placed in service on or before September 30, 1985. Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, was only allowable ratably over 5 years, rather than entirely in the year the property is placed in service.

Notwithstanding these general rules, finance leasing was to be available for up to $150,000 per calendar year of a lessee's farm property for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of the investment credit did not apply to this amount of farm property.

The Tax Reform Act of 1984, however, postponed the effective date of the finance lease rules to generally apply to agreements entered into after December 31, 1987, and extended the three restrictions. Thus, the 40-percent lessee cap was extended to property placed in service by a lessee during any calendar year beginning before 1990; the 50-percent lessor cap was extended through September 30, 1989; and the 5-year spread of the investment credit for property subject to a finance lease was extended to property placed in service on or before September 30, 1989.

The Tax Reform Act of 1984 provided transitional rules which exempted property from the 4-year postponement if, before March 7, 1984, (1) a binding contract to acquire or construct the property was entered into by or for the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee. In addition, the Act exempted from the 4-year postponement property which is placed in service before 1988 and is (1) a qualified lessee's automotive manufacturing property (limited to an aggregate of $150 million of cost basis per lessee) or (2) property that was part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates. The special rules relating to the availability of finance leasing for up to $150,000 per calendar year of a lessee's farm property were extended to cover agreements entered into before 1988.

Reasons for Change

Equitable taxation

The committee believes that reform of the capital cost recovery rules is essential for the achievement of more equitable taxation.

The present rules have two major components: the investment tax credit and depreciation (ACRS) deductions. The credit is available when an asset is placed in service, and ACRS deductions, which begin at the same time, are allowed over a period that is generally much shorter than the actual service life of the asset. In combination, the credit (measured as a deduction of equal tax-reducing effect) and ACRS give taxpayers writeoffs that exceed the cost of an asset and concentrate the writeoffs in the early years of the asset's service life. For example, a corporation in the top tax bracket can now write off about 110 percent of the cost of a new car in just three years, even though the car, as noted in government and industry reports, will on average remain in operation for an additional seven or eight years.

The committee is very concerned about the significant inequities that result from the amount and concentration of these tax benefits. Individuals and corporations who have considerable amounts of economic income are permitted to pay little or no tax by using the credit and ACRS, while others with equal or lesser incomes are left fully exposed to high tax rates. The committee believes that inequities of this magnitude should not continue as a regular feature of the tax system, whose orderly functioning rests squarely on popular opinion that it is operating fairly. Therefore, the committee bill goes to the source of the problem by repealing the investment tax credit and providing for generally longer depreciation periods that are more systematically related to service lives.

Economic growth

The committee believes that these reforms, in conjunction with lower marginal tax rates, lay a more certain foundation for growth of the nation's economy.

Proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investment in such property, which in turn would pull the entire economy into more rapid growth. The committee perceives that nothing of this kind

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has happened. First, the average annual compound rate of real growth in equipment spending since 1980 has been very close to the historical trend dating from the early 1960's, and the rate of overall economic growth has been smaller. Second, the growth which has occurred in equipment spending has been heavily concentrated in computers and automobiles, assets which by standard measures of investment incentives received no boost from the 1981 Act. Third, the benefits provide no immediate expansionary stimulus to new or rebuilding enterprises that lack the taxable income to turn credits and deductions into tax savings. These enterprises have resorted to a maze of secondary transactions (such as sale-leasebacks) in order to realize a portion of the tax benefits, stimulating a diversion of highly trained resources to the business of marketing tax benefits and away from the more efficient production of goods and services. Fourth, the investment tax credit and ACRS deductions provide little expansionary stimulus to the service, small business, high technology and other important sectors of the economy that do not make extensive use of depreciable assets but do contribute to economic growth and will benefit from lower tax rates.

But the committee's fundamental view, embodied also in contemporaneous proposals for tax reform, is that the tax system makes the greatest contribution to economic growth when it has the lowest possible tax rates and does not try to prescribe how growth will happen. The strategy that any particular business might choose as most promising—whether to employ more or less equipment or labor, adopt different management practices, alter marketing and purchasing procedures, and so on—is a matter the committee feels is best left to private decisionmaking, undistorted by large tax preferences which presume that one answer fits all cases. This is another reason for the committee's decisions to scale back special tax benefits for expenditures on depreciable assets and to lower marginal tax rates.

The committee is not of the view, however, that the current tax advantages for investment in depreciable property should be replaced by a system having no preferences at all. Rather, the committee believes that the intermediate degree of acceleration that was available prior to 1981 under the ADR system is generally the right target. Therefore, the committee bill permits the 200-percent declining balance method of depreciation and generally uses ADR midpoint lives for assigning assets to recovery classes and for determining recovery periods.

The committee also believes that the depreciation system should be amended to afford taxpayers limited protection against loss of real value in depreciation deductions due to excessive inflation.

The committee is aware that commitments have already been made on the basis of present law capital cost recovery rules. The committee bill provides for equitable transition rules in such cases, which are estimated to cover more than 50 percent of the new personal property to be placed in service in the first year the bill is effective.

Simplicity

The committee believes that the restructured depreciation system should operate as simply as is possible. The committee bill consolidates the numerous different depreciation treatments of present law into two basic integrated systems. Moreover, a factor in the committee's decision to use the asset classifications of ADR is taxpayers' prior experience and familiarity with those classifications. Finally, the committee believes that small businesses should be able to expense larger amounts than at present, so that fewer of them need enter into depreciation computations.

Explanation of Provisions

1. Depreciation

a. Overview

The bill replaces the Accelerated Cost Recovery System ("ACRS") with the Incentive Depreciation System for tangible property ("incentive system" or "IDS"). Under IDS, assets are grouped into ten classes, generally on the basis of similar present class lives. Each IDS class is assigned a depreciation method and a recovery period. The IDS methods of cost recovery and recovery periods are the same for both new and used property.

The bill's incentive system is mandatory for all eligible property, although a taxpayer can elect to use a nonincentive system and recover capital costs using the straight-line depreciation method over an asset's present class life. The entire cost or other basis of eligible property is recovered under IDS, without regard to salvage value.

The bill includes a provision for limited expensing of eligible property, and a nonincentive depreciation system for (1) assets used abroad, (2) assets used by nontaxable entities, (3) computing earnings and profits of a corporation, (4) assets financed with the proceeds of tax-exempt obligations, (5) certain assets predominantly used in the business of a timber producer, (6) assets used by farmers who elect to deduct certain preproductive period expenses, and (7) computing the alternative minimum tax applicable to corporations and individuals. The bill also includes normalization requirements for assets used by public utilities.

Under the bill, if a lessee makes improvements to leased property, the cost of the leasehold improvement is recovered under the same rules that apply to an owner of property.

For tangible property placed in service after the date of enactment, depreciation deductions will be subject to adjustments for inflation, beginning in 1988.

b. General rules

With limited exceptions, assets are grouped into ten classes according to present class lives (or "midpoint lives") under the Asset Depreciation Range ("ADR") system, in effect as of January 1, 1985. The depreciation method applicable to property included in IDS Classes 1-9 is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. The cost of property included in IDS Class 10 is recov-

ered using the straight-line method. In all cases, the salvage value of property is treated as zero; thus, the entire cost or other basis of eligible property is recovered under IDS.

Except for Class 1 and Class 10, the recovery period for each IDS class is generally equal to the ADR midpoint life of the asset with the lowest ADR midpoint in the class. For example, IDS Class 2 includes personal property with ADR midpoint lives of at least 5 but less than 7 years, and the recovery period for IDS Class 2 property is 5 years. The recovery period for IDS Class 1 is 3 years, and the recovery period for IDS Class 10 is 30 years.

Personal property that has no ADR midpoint life and is not otherwise assigned to an IDS class is included in IDS Class 4.

Eligible property

Under the bill, property eligible for IDS generally includes tangible depreciable property (both real and personal), whether new or used, placed in service after December 31, 1985. Eligible property does not include (1) the portion of the basis of any property that is amortized under section 167(k) (relating to expenditures for the rehabilitation of low-income rental housing), (2) property the taxpayer properly elects to depreciate under the unit-of-production method or any other method not expressed in terms of years (other than the retirement-replacement-betterment method or similar method), (3) any property used by a public utility (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting, (4) any motion picture film or video tape, (5) any sound recording described in section 280(c)(2), or (6) any property subject to ACRS or pre-ACRS depreciation rules (by application of an effective date rule).

Normalization requirements for public utility property

The bill provides that public utility property is eligible for IDS only if the tax benefits of IDS are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.

If a normalization method of accounting for IDS deductions is not used with respect to property placed in service after December 31, 1985, such property is not eligible for the bill's accelerated depreciation method. If a normalization method of accounting is not used, the bill provides that a depreciation allowance for such property is to be determined under Code section 167(a), using a depreciation method the same as, and a useful life no shorter than, the depreciation method and useful life used to compute the depreciation allowance for the property for purposes of setting rates and reflecting operating results in regulated books of account. For this purpose, averaging conventions and salvage value limitations are considered part of the ratemaking depreciation method.

Under the bill, the benefits of the bill's depreciation allowances that must be normalized include those attributable to the bill's prescribed depreciation method, the recovery period, the averaging convention, the salvage value rules, and inflation indexing (described below). Therefore, ratemaking depreciation methods, useful lives, placed in service rules, and salvage value rules are to be used

in determining the amount of deferred taxes that result from using the Incentive Depreciation System.

The bill does not restrict the authority of regulatory bodies to treat the deferred taxes as zero-cost capital or as a reduction in rate base in setting rates. The amount of capital treated as zero-cost capital and the amount of rate base reduction are not to exceed the amount of deferred taxes that result from the taxpayer's use of IDS.

In addition to requiring that IDS deductions must be normalized, the bill provides for the normalization of the excess deferred tax reserve resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before 1986). The bill provides that if the excess deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer is not considered to be using a normalization method of accounting with respect to any of its assets. Thus, if the excess deferred tax reserve is not normalized, the taxpayer must compute its depreciation allowances using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in regulated books of account.

The bill provides that the excess deferred tax reserve is the reserve for deferred taxes computed under prior law over what the reserve for deferred taxes would be if the tax rate in effect under the bill had been in effect for all prior periods. The average rate assumption method is the method which reduces the excess deferred tax reserve over the remaining regulatory lives of the property which gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (i.e., differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. Under the bill, the excess deferred tax reserve is multiplied by a formula that is designed to help insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

The committee does not intend that the provisions apply retroactively to the excess deferred tax reserve generated from previous reductions in corporate tax rates. The committee intends that such previous excess deferred tax reserves will continue to be treated under prior law.

Classification of assets and recovery periods

IDS Class 1

IDS Class 1 includes all property with an ADR midpoint life of less than 5 years, other than automobiles, taxis, and light general purpose trucks (described in ADR class .241). This class also includes any clothing held for rental (which would otherwise be included in IDS Class 3 by virtue of a 9-year ADR midpoint life).

The cost of property included in IDS Class 1 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 3-year recovery period.

IDS Class 2

IDS Class 2 includes property with ADR midpoint lives of at least 5 but less than 7 years. This class also includes (1) light general purpose trucks (described in ADR class .241), automobiles, and taxis, (2) any "qualified technological equipment," (3) any computer-based telephone central office switching equipment described in ADR class 48.12, and (4) racehorses.

The committee's decision to assign cars and light trucks to Class 2 was based on clear information that the 3-year recovery period of class 1 would be much too short for these assets. According to industry information, the expected median lifetime of a new car is nearly 11 years, and more than 93 percent of new cars will have a lifetime of 5 years or more. Similarly, the expected median lifetime of a new light truck is nearly 15 years, and more than 94 percent of the trucks will have a lifetime of 5 years or more. About two-thirds of new car buyers who financed their purchase with debt chose a payback period of 4 to 5 years. This also appears to be the range of common lease terms advertised by new car dealers. These data indicate to the committee that a recovery period of at least 5 years is appropriate.

The term "qualified technological equipment" generally has the same meaning as under the tax-exempt leasing rules of present law: any computer or peripheral equipment, high-technology telephone station equipment installed on the customer's premises (described in ADR class 48.13), and high-technology medical equipment (i.e., any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment).

Telephone central office switching equipment is computer-based only if it could function as a computer and peripheral equipment (as defined in section 168(j)(4)(B)) in uses other than as telephone central office switching equipment. The identical qualities of this computer-based equipment and computers are the committee's basis for placing the computer-based equipment in IDS Class 2 (rather than IDS Class 6, which would otherwise follow from its 18-year ADR midpoint life) along with computers. The committee bill assigns racehorses to Class 2 to avert the 10-year recovery period, which the committee perceives would be unreasonable, that would otherwise follow because racehorses have no present class life under present law.

The cost of property included in IDS Class 2 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 5-year recovery period.

IDS Class 3

IDS Class 3 includes property with ADR midpoint lives of at least 7 but less than 10 years. The cost of property included in IDS

Class 3 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 7-year recovery period.

IDS Class 4

IDS Class 4 includes property with ADR midpoint lives of at least 10 but less than 13 years. Personal property that has no ADR midpoint life and is not assigned otherwise is included in IDS Class 4. Examples of property without an ADR midpoint life are ship containers, railroad track, and recreational vehicles. IDS Class 4 also includes all horses other than racehorses.

The cost of property in IDS Class 4 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 10-year recovery period.

IDS Class 5

IDS Class 5 includes property with ADR midpoint lives of at least 13 but less than 16 years. This class also includes any single-purpose agricultural or horticultural structure. A single-purpose agricultural or horticultural structure is defined in section 48(p) to include (1) any enclosure or structure specifically designed, constructed, and used for housing, raising, and feeding a particular type of livestock and their produce, and (2) a greenhouse specifically designed, constructed, and used for the commercial production of plants.

The cost of property included in IDS Class 5 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 13-year recovery period.

IDS Class 6

IDS Class 6 includes property with ADR midpoint lives of at least 16 years but less than 20 years. The cost of property in IDS Class 6 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 16-year recovery period.

IDS Class 7

IDS class 7 includes property with ADR midpoint lives of at least 20 years but less than 25 years, plus "very low-income housing." Very low-income housing is low-income housing (discussed below) in which 40 percent or more of the units are occupied by individuals whose income is 60 percent or less of median gross income. The assignment of very low-income housing to Class 7 reflects the committee's decision that depreciation deductions for this property should be approximately 50 percent greater (in present value terms) than depreciation deductions for rental housing that does not qualify as low-income housing.

The cost of property in IDS Class 7 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 20-year recovery period.

IDS Class 8

IDS Class 8 includes property with ADR midpoint lives of at least 25 but less than 30 years. It also includes any telephone distribution plant (as described in ADR Class 48.14) and comparable equipment used by other transmitters of information (e.g., cable television operators). The committee intends that equipment be treated as comparable to telephone distribution plant if the equipment has substantially the same useful life as telephone distribution plant and performs (or is suitable for performing) substantially the same function as telephone distribution plant.

The cost of an asset in IDS Class 8 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 25-year recovery period.

IDS Class 9

IDS Class 9 includes property with ADR midpoint lives of at least 30 years but less than 36 years plus low-income housing that is not very low-income housing. The assignment of low-income housing to Class 9 reflects the committee's decision that depreciation deductions for this property should be approximately 25 percent greater in present value terms than depreciation deductions for rental housing that does not qualify as low-income housing.

The cost of property in IDS Class 9 is recovered using the double declining balance method, switching to the straight-line method at the time which maximizes the deduction, and a 30-year recovery period.

IDS Class 10

IDS Class 10 includes property with an ADR midpoint life of at least 36 years plus any real property that does not have a class life and is not low-income housing (referred to as "30-year real property").

The cost of property included in IDS Class 10 is recovered using the straight-line method and a 30-year recovery period.

Rules relating to low-income housing

In general, low-income housing is defined as any real property that is part of a residential rental project, if (at the taxpayer's election when the property is placed in service) either 20 percent or more of the units are occupied by individuals whose income is 70 percent or less of median gross income, or 25 percent or more of the units are occupied by individuals whose income is 80 percent or less of median gross income. Property will not fail to qualify as residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes. Further, rules similar to the rules of paragraphs (2), (3), and (4) of section 142(c), relating to holding-period and annual-certification requirements for low-income housing financed with tax-exempt bonds, apply for purposes of determining whether property is low-income housing.

Changes in classifications

The Secretary, through an office established in the Treasury Department (including the Internal Revenue Service), is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property when appropriate, and to prescribe a class life for any property that does not have a class life. If the Secretary prescribes a new class life for property (other than 30-year real property or low-income housing), including property that is assigned a class life under the bill, such life will be used in determining the classification of the property.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Thus, useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property which the committee intends the Secretary will take into account in prescribing a class life includes the depreciation practices followed by taxpayers for book purposes with respect to the property. It also includes useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life—the terms for which new property is leased, used under a service contract, or financed—and independent evidence afforded by resale price data. The committee intends that the prescribed class lives should not incorporate adjustments for inflation; appropriate inflation adjustments to depreciation deductions are provided by the bill.

The committee believes that the proper operation of IDS depends heavily on keeping current the class lives of all assets. Therefore, the bill contemplates that, pursuant to the authority to prescribe or revise class lives, the Secretary will give priority to the following items: (1) machine tools (described in Standard Industrial Classification Codes 3541 and 3542), (2) scientific instruments for laboratory research, production, quality control, and regulatory compliance, (3) telephone distribution plant and comparable equipment used by other transmitters of information, (4) single purpose agricultural structures, and (5) mobile homes and offices. The Secretary is expected to determine the appropriate class lives for the noted property within one year of the date of enactment of the bill. The committee also expects that initial studies will concentrate on property which now has no ADR midpoint life and property which the bill assigns to a different IDS class than would follow from its present ADR midpoint life.

Averaging conventions

The following averaging conventions apply to depreciation computations made under both the incentive and nonincentive depreciation systems provided by the bill.

Half-year convention

In general, a half-year convention applies under which all property placed in service or disposed of during a taxable year is treat-

ed as placed in service or disposed of at the mid-point of such year. As a result, a half-year of depreciation is allowed for the first year property is placed in service, regardless of when the property is placed in service during the year, and a half-year of depreciation is allowed for the year in which property is disposed of or is otherwise retired from service.

To illustrate the half-year convention, assume that a taxpayer places in service in taxable year 1 a $100 asset assigned to Class 2 by reason of a 5-year class life. IDS deductions, beginning with taxable year 1 and ending with taxable year 6, are $20, $32, $19.20, $11.52, $11.52, and $5.76. If the asset were disposed of in taxable year 2, the IDS deduction for that year would be $16.

Mid-month convention

In the case of low-income housing and any property included in IDS Class 10, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Further, property disposed of by a taxpayer at any time during a month is treated as having been disposed of in the middle of the month.

Special rule where substantial property placed in service during last quarter of year

Except as provided in regulations, the mid-month convention applies to all property a taxpayer places in service during a taxable year if more than 40 percent of the aggregate bases of that property is placed in service during the last quarter of the taxable year. For purposes of applying the 40-percent test, low-income housing and IDS Class 10 property are not taken into account.

c. Inflation adjustments

IDS deductions will be subject to an increase for inflation adjustments, beginning in 1988. This increase is available only with respect to assets that are both (1) depreciable under the Incentive Depreciation System and (2) placed in service after the date of enactment of the bill. Thus, for example, the increase is not available with respect to assets to which ACRS applies or for which the nonincentive depreciation system (described below) of the bill must be used. However, this increase is available for property for which the taxpayer elects nonincentive depreciation.

In general, a taxpayer's depreciation deduction (inclusive of any increase for inflation) for an item of property is that deduction (exclusive of any such increase) multiplied by the product of the allowable inflation adjustments for the taxable year and each prior taxable year during the taxpayer's holding period of the property. An inflation adjustment is computed for a taxable year only if inflation for the calendar year in which the taxable year begins exceeds 5 percent (expressed in decimal terms). In that event, the inflation adjustment is the sum of (1) one, plus (2) one-half of the inflation rate in excess of 5 percent. For this purpose, inflation in a calendar year is the percentage increase in the CPI (defined under sec.

1(e)(4)) over the one-year period ending with August 31 of that calendar year.

No inflation adjustment is allowed for any taxable year (1) in which property is placed in service or disposed of or (2) beginning in a calendar year before 1988. Moreover, an asset is not eligible for an inflation adjustment until it is placed in service in a trade or business or for the production of income. For example, if an asset is held for personal use and then converted to business use, no inflation adjustment is taken into account for the period prior to the time the asset is converted to business use.

These provisions can be illustrated with a numerical example in which dollar amounts have been rounded to the nearest penny. Assume that a calendar year taxpayer buys an IDS Class 1 asset for $100, places it in service in 1987, and continues to use it beyond 1990. IDS deductions without regard to inflation would be $33.33 in 1987, $44.45 in 1988, $14.81 in 1989, and $7.41 in 1990. No inflation adjustment is made for 1987, because that is the year the property is placed in service; furthermore, the bill allows no adjustment for a taxable year beginning in a calendar year before 1988. Assuming that inflation proved to be 7 percent in 1988 and 1989, and 5 percent in 1990, the corresponding inflation adjustments would be 1.01 for 1988 and 1989; no inflation adjustment would be computed for 1990. Deductions inclusive of inflation adjustments, if any, would therefore be $33.33 in 1987, $44.89 (which is $44.45 times 1.01) in 1988, $15.11 (which is $14.81 times 1.01 twice) in 1989, and $7.56 (which is $7.41 times 1.01 twice) in 1990.

The bill provides that the amount by which a depreciation deduction is increased due to the operation of inflation adjustments is not considered a depreciation deduction for purposes of determinating adjusted basis and the amount (and character) of gain or loss on disposition of property. In the case of any property used in an activity to which the at-risk rules of section 465 apply, if a depreciation deduction is disallowed for a taxable year, then the amount attributable to an inflation adjustment is also carried forward to the taxable year for which the related depreciation deduction is allowed. Further, inflation adjustments that are allowed as additional deductions do not reduce the at-risk amount under section 465.

The bill provides that for all other purposes of the Code, the additional deduction resulting from the inflation adjustment is treated as a depreciation deduction. For example, the additional deduction is treated as a tax preference item, reduces net investment income for the purposes of the limitation on the deductibility of investment interest, counts toward luxury car depreciation limitations, and is subject to the normalization requirements for public utility property. With regard to the latter, the committee intends that the additional deduction resulting from the inflation adjustment shall not be flowed through to ratepayers more rapidly than ratably over the remaining regulatory life of the asset in order for the taxpayer to be considered as using a normalization method of accounting.

The committee intends that inflation adjustments applicable to an asset will carry over to a transferee in a nonrecognition transaction where the basis of the asset acquired is determined by reference to the basis of the asset transferred.

d. Nonincentive depreciation system

In general

In general, IDS deductions are reduced for property that (1) is used predominantly outside the United States ("foreign-use" property), (2) is leased to or otherwise used by a tax-exempt entity, including a foreign person unless more than 50 percent of the gross income derived from the property by such person is subject to U.S. tax ("tax-exempt use" property), (3) is financed directly or indirectly by an obligation, the interest on which is exempt from taxation under section 103(a) ("tax-exempt bond financed" property), (4) is imported from a foreign country with respect to which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts, or (5) with respect to which an election to decelerate depreciation deductions is made.

In these cases, depreciation allowances are computed under the nonincentive depreciation system, which provides for straight-line recovery (without regard to salvage value) and use of the applicable averaging conventions described above. In general, the recovery period under the nonincentive system is equal to the property's ADR midpoint life (12 years for personal property with no ADR midpoint life, and 40 years for real property). For an asset that is classified under a special rule in the bill (e.g., computer-based telephone switching equipment that has an ADR midpoint life of 18 years but is included in a class of property with ADR midpoint lives of 5 to 6.5 years), the recovery period applicable to such property under the incentive system is treated as the property's ADR midpoint life for purposes of the nonincentive system. Similarly, the applicable recovery period is 20 years (the recovery period for IDS Class 7) for very low-income housing and 30 years (the recovery period for IDS Class 9) for low-income housing. Special rules apply for determining the recovery period of tax-exempt bond financed property and certain tax-exempt use property.

The nonincentive depreciation system is used for purposes of computing the earnings and profits of a foreign or domestic corporation, as well as for purposes of computing the portion of depreciation allowances treated as an item of tax preference under the alternative minimum tax applicable to corporations and individuals. The nonincentive depreciation system also applies to an electing farmer who deducts currently preproductive costs (provided in sec. 905 of the bill), and qualified small timber producers who elect to amortize costs rather than add them to the basis of the timber (provided in sec. 911 of the bill).

Foreign-use property

As under ACRS, foreign-use property is property that is used outside the United States more than half of a taxable year. In addition to the exceptions to this general rule that are applicable for purposes of ACRS, the bill provides a new exception for any satellite or other space craft (or any interest therein) held by a U.S. person if such property is launched from within the United States.

Tax-exempt use property

In the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of computing nonincentive depreciation is increased to a period not less than 125 percent of the lease term, if this period would be longer than the nonincentive depreciation period otherwise applicable to the property. This rule is inapplicable to qualified technological equipment (other than equipment that is (1) leased to a tax-exempt entity or a related party after a sale or other transfer from one of such persons, if the equipment was used by such person before the disposition, (2) financed with tax-exempt obligations, or (3) used by the Federal Government or an agency or instrumentality of the United States).

Tax-exempt bond financed property

In the case of tax-exempt bond financed property (other than any low-income housing), the recovery period used for purposes of nonincentive depreciation is equal to the period determined by ascertaining the IDS class into which such property would fall otherwise, and then using the IDS recovery period for the next longer class (40 years for IDS Class 9 or 10 property). For example, if IDS Class 8 property is financed with the proceeds of tax-exempt bonds, the recovery period used for purposes of nonincentive depreciation would be 30 years (the IDS Class 9 recovery period). The proceeds of a tax-exempt obligation are treated as used to finance property acquired in connection with the issuance of such obligation in the order in which the property was acquired.

Certain imported property

The bill authorizes the President to provide by Executive Order for the application of the nonincentive depreciation system to certain property that is imported from a country maintaining trade restrictions or engaging in discriminatory acts. For purposes of this provision, the term imported property means any property that is completed outside the United States, or less than 50 percent of the basis of which is attributable to value added within the United States. In applying this test, the term "United States" is treated as including the Commonwealth of Puerto Rico and the possessions of the United States.

The bill authorizes reduced depreciation for property that is imported from a foreign country that (1) maintains nontariff trade restrictions that substantially burden U.S. commerce in a manner inconsistent with provisions of trade agreements, including variable import fees, or (2) engages in discriminatory or other acts or policies unjustifiably restricting U.S. commerce (including tolerance of international cartels). If the President determines that a country is engaging in the proscribed actions noted above, he may provide for the application of nonincentive depreciation to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive Order.

In general, the terms of the provision relating to certain imported property are substantially identical to those of section 48(a)(7) relating to the investment tax credit (which is repealed by sec. 211 of the bill).

Election to use nonincentive depreciation system

A taxpayer may irrevocably elect to apply the nonincentive system to any IDS class of property for any taxable year. If the election is made, the nonincentive system applies to all property in the IDS class placed in service during the taxable year. The increase in depreciation deductions for inflation (discussed above) is available to property for which the nonincentive system is elected (and not required).

e. Mass asset vintage accounts

Under regulations prescribed by the Secretary, a taxpayer may maintain one or more mass asset accounts for any property in the same IDS class and placed in service in the same year. Unless otherwise provided in regulations, the full amount of the proceeds realized on disposition of property from a mass asset account are to be treated as ordinary income (without reduction for the basis of the asset). As a corollary, no reduction is to be made in the depreciable basis remaining in the account.

f. Lessee leasehold improvements

The cost of leasehold improvements made by a lessee is to be recovered under the rules applicable to other taxpayers, without regard to the lease term. On termination of the lease, the lessee who does not retain the improvements is to compute gain or loss by reference to the adjusted basis of the improvement at that time.

g. Treatment of certain transferees

A special rule applies after the transfer of any property in a nonrecognition transaction described in section 332, 351, 361, 371(a), 374(a), 721, or 731. In any such case, the transferee is treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. Thus, the transferee of property in one of the transactions described above "steps into the shoes" of the transferor to the extent the property's basis is not increased as the result of the transaction. To the extent the transferee's basis exceeds the property's basis in the hands of the transferor (e.g., because the transferor recognized gain in the transaction), the transferee depreciates the excess under the bill's general rules.

h. Additions or improvements to property

Component depreciation cannot be used. Thus, for example, the recovery period and method applicable to a building must be used for all structural components that are real property (*e.g.*, wiring, plumbing, etc.). The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.

i. Changes in use of IDS property

The Secretary is authorized to prescribe regulations providing for the method of determining depreciation allowances for any taxable year (and succeeding taxable years) during which the status of property changes but continues to be held by the same person. The bill provides a special rule for low-income housing that ceases to qualify as such.

In the case of property that qualified as low-income housing before a change in status (including ceasing to be very low-income housing), (1) previously claimed "excess depreciation deductions" are recaptured (i.e., included in the gross income of the holder of such property in the year of change of status), and (2) the adjusted basis as increased by the amount recaptured is depreciated over the remaining recovery period that would have applied to the property if it had not qualified as low-income housing when placed in service. For purposes of this rule, the term "excess depreciation deductions" means the excess of (1) the depreciation deductions previously allowable while the property qualified as low-income housing, over (2) the depreciation deductions" that would have been allowable if such property had been treated as 30-year real property when placed in service.

j. Expensing in lieu of cost recovery

The bill continues the provision under which a taxpayer (other than a trust or estate) can elect to treat the cost of qualifying property as an expense that is not chargeable to capital account, with several modifications. The costs for which the election is made are allowed as a deduction for the taxable year in which the qualifying property is placed in service.

Under the first modification, the dollar limitation on the amount that can be expensed is $10,000 a year ($5,000 in the case of a married individual filing a separate return). The second modification provides that the election to expense qualifying property is unavailable to any taxpayer for any taxable year in which the aggregate cost of qualifying property placed in service during such taxable year exceeds $200,000.

k. Disposition of assets and recapture

If a taxpayer uses the bill's incentive system to recover the costs of tangible property (other than 30-year real property and low-income housing), all gain on the disposition of such property is recaptured as ordinary income to the extent of previously allowed depreciation deductions. For purposes of this rule, any deduction allowed under section 179 (relating to the expensing of up to $10,000 of the cost of qualifying property), 190 (relating to the expensing of the costs of removing certain architectural and transportation barriers), or 193 (relating to tertiary injectant expenses) is treated as a depreciation deduction.

In the case of 30-year real property and low-income housing, only the excess of accelerated deductions over straight-line deductions, using the recovery period applicable to such property, is recaptured, and the phaseout of recapture applicable to low-income housing under present law is repealed. For example, for very low-

income housing that is depreciated over a 20-year period using the double-declining balance method, the excess of the accelerated deductions over straight-line deductions—using a 20-year recovery period—is subject to recapture. If low-income housing is sold and leased back by a taxpayer, and the property is not used as low-income housing after the leaseback, the Secretary is authorized (by regulation) to determine the amount subject to recapture by reference to the excess of (1) accelerated depreciation using the recovery period and method applicable to low-income housing over (2) straight-line depreciation over 30 years.

2. Regular Investment Tax Credit

The bill repeals the regular investment tax credit.

3. Finance Leases

The bill repeals the finance leasing rules.

Effective Dates

In general, these provisions apply to all property placed in service after December 31, 1985. As a result, generally, neither ACRS nor the regular investment credit is available to property that is placed in service on or after January 1, 1986.

The bill provides certain exceptions to the general effective dates, in the case of property constructed, reconstructed, or acquired pursuant to a written contract that was binding as of September 25, 1985, or in other transitional situations discussed below. Except in the case of certain qualified solid waste disposal facilities (described below), the application of the bill's transitional rules is conditioned on property being placed in service by a prescribed date in the future. In addition, special rules are provided for investment credits claimed on transitional property, tax-exempt bond financed property, the finance lease rules, and the application of depreciation recapture rules to certain real property.

The transitional rules described below do not apply to any property unless the property is placed in service before the applicable date, determined according to the following: (1) for property that would be in IDS Class 1, July 1, 1986, (2) for property that would be in IDS Class 2, January 1, 1987, (3) for property that would be in IDS Class 3, 4, 5, or 6, January 1, 1989, and (4) for property that would be in IDS Class 7, 8, 9, or 10, January 1, 1991.

For purposes of the placed-in-service requirement, light general purpose trucks (described in ADR class .241), automobiles and taxis are treated as IDS Class 1 property.

For purposes of the general effective date, if at least 80 percent of a target corporation's stock is acquired before December 31, 1985, and the acquiring corporation makes a section 338 election to treat the stock purchase as an asset purchase after that date, then the deemed new target corporation is treated as having purchased the assets before the general effective date.

Binding contracts

The bill does not apply to property that is constructed, reconstructed, or acquired by a taxpayer pursuant to a written contract that was binding on September 25, 1985, and at all times thereafter. If a taxpayer transfers his rights in any such property under construction or such contract to another taxpayer, the bill does not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1)(B), the partnership is to be treated as having transferred its rights in the property under construction or the contract to the new partnership.

The general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract.

A contract is binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provisions). A contractual provision that limits damages to an amount equal to at least five percent of the total contract price is not treated as limiting damages.

For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment.

In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor (except in the limited circumstances described below). For example, a binding contract to build an ethanol plant comes within the scope of the rule, even though the parties are awaiting a federal guarantee. A contract that was binding on September 25, 1985, will not be considered binding at all times thereafter if it is substantially modified after that date. A waiver of a right to cancel upon a price change is an example of a substantial modification.

A binding contract to acquire a component part of a larger property will not be treated as a binding contract to acquire the larger property under the general rule for binding contracts. For example, if a written binding contract to acquire an aircraft engine was entered into on September 25, 1985, there would be a binding contract to acquire only the engine, not the entire aircraft.

The committee agreed that the general binding contract rule is to inlcude property that is the subject matter of a certain letter agreement between a party acting as a general contractor and two automobile manufacturers, which agreement was entered into in a time zone outside of the United States as of September 25, 1985, in the Eastern Daylight Time Zone in the United States. The property eligible for this treatment consists of an automobile manufacturing facility (and equipment and incidental appurtenances) to be located in the United States. In such case, the letter agreement for the

party to act as the general contractor for construction of the facility is to be treated as a binding contract even if the agreement is subject to conditions within the control of one party, as long as that party used best efforts to secure their occurrence, and the agreement is in fact finalized.

Self-constructed property

The bill does not apply to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of September 25, 1985, and (2) the construction or reconstruction began by that date. For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

Equipped buildings

Under the bill, where construction of an equipped building began on or before September 25, 1985, pursuant to a written specific plan, and more than one-half the cost of the equipped building (including any machinery and equipment for it) was incurred or committed before September 26, 1985, the entire equipped building project and incidental appurtenances are excepted from the bill's application. Where the costs incurred or committed before September 26, 1985, do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transitional relief.

Under the equipped building rule, the bill will not apply to equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(1) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific written plan of a taxpayer in existence on September 25, 1985; and

(2) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the written plan) was attributable to property the cost of which was incurred or committed by September 25, 1985, and construction commenced on or before September 25, 1985.

The written plan for an equipped building may be modified to a minor extent after September 25, 1985 (and the property involved still come under this rule); however, there cannot be substantial modification in the plan if the equipped building rule is to apply. The plan referred to must be a definite and specific plan of the tax-

payer that is available in written form as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a $100,000 building with $80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building, that are not themselves located in the building. Assume that the incidental appurtenances have further costs of $30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, do not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if the building qualified as transition property but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, the equipped building rule would apply. This is true because the building cost represents more than 50 percent of the total $180,000. As a result, the machinery and equipment, even though not under binding contract, is eligible for the rule. In this connection, it should be noted that the additional cost of appurtenances, $30,000, is not taken into account for purposes of determining whether the 50-percent test is met. Nevertheless, the bill would not apply to these appurtenances since the 50-percent test is met as to the equipped building.

In general, costs are committed if they are required to be incurred pursuant to a written contract that was binding as of September 25, 1985. The committee agreed, however, that the equipped building rule is to apply to an automobile manufacturing facility (and equipment and incidental appurtenances) constructed pursuant to a plan approved by an automobile manufacturer's board of directors before August 1, 1985, and in connection with an arrangement involving a second automobile manufacturer that agrees to purchase 50 percent of the output from the facility (and to supply the engines for the output so purchased). In such case, 50 percent of the cost of the equipped building is to be treated as incurred before September 25, 1985.

Plant facilities

The bill also provides a plant facility rule that is comparable to the equipped building rule (described above), for cases where the facility is not housed in a building.

If pursuant to a written specific plan of a taxpayer in existence on September 25, 1985, the taxpayer constructed, reconstructed, or erected a plant facility, the construction, reconstruction, or erection commenced before September 26, 1985, and the 50-percent test is met, then the bill will not apply to property that makes up the facility. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the

facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

Special rule for sale-leasebacks within 90 days

Property is treated as meeting the requirements of the general binding contract rule, the equipped building rule, or the plant facility rule, if (1) the property is placed in service by a taxpayer who acquired the property from a person in whose hands the property would qualify under such transitional rules, (2) the property is leased back by the taxpayer to such person, and (3) the leaseback occurs within 90 days after such property was originally placed in service, but no later than the applicable date. The committee intends that the special rule for sale-leasebacks apply to any property that qualifies for transitional relief under the bill. For purposes of this rule, a leaseback to a taxpayer's wholly-owned subsidiary included in the same affiliated group is to be treated as a leaseback to the taxpayer.

Special rules for tax-exempt bond financed property

The provision restricting IDS deductions for property financed with tax-exempt bonds applies to property placed in service after December 31, 1985, to the extent that such property is financed by the proceeds of bonds issued after September 25, 1985. The restrictions on IDS deductions do not apply to facilities placed in service after December 31, 1985, if—

(1) the original use of the facilities commences with the taxpayer and the construction (including reconstruction or rehabilitation) commenced before September 26, 1985, and was completed after that date;

(2) a binding contract to incur significant expenditures for the construction (including reconstruction or rehabilitation) of the property financed with the bonds was entered into before September 26, 1985, was binding at all times thereafter, and some or all of the expenditures were incurred after Septemer 25, 1985; or

(3) acquired after September 25, 1985, pursuant to a binding contract entered into on or before September 26, 1985, and that is binding at all times after September 25, 1985.

For purposes of this restriction, the determination of whether a binding contract to incur significant expenditures existed before September 26, 1985, is made in the same manner as under the rules governing the redefinition of governmental bonds.

The restrictions on cost recovery deductions for bond-financed property do not apply to property placed in service after December 31, 1985, to the extent that the property is financed with tax-exempt bonds issued before September 26, 1985. Cost recovery deductions for such property may be determined, however, under the

new cost recovery rules generally provided by the bill. For purposes of this exception, a refunding issue issued after September 25, 1985, generally is treated as a new issue and the taxpayer must use the slower recovery methods and periods for costs that are unrecovered on the date of the refunding issue.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and recovery period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required when a pre-September 26, 1985, bond issue is refunded where no significant expenditures are made with respect to the facility after December 31, 1985.

Contract with persons other than a person who will construct or supply the property

The bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before September 26, 1986. An example of a case to which this rule would apply is that of a taxpayer who entered into a written binding power sales contract before September 26, 1985, and is required to construct (or have constructed) two facilities that will produce the power necessary to fulfill the contractual obligation. Another example would be lease agreements under which a grantor trust is obligated to provide property under a finance lease (to the extent continued under the bill).

This transitional rule is applicable only where the specifications of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). This rule does not provide transitional relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transitional relief.

Development agreements relating to large-scale multi-use urban projects

The bill does not apply to property that is included in a "qualified urban renovation project." The term qualified urban renovation project includes certain projects that satisfy the following requirements on or before September 25, 1985: the project is described in the bill and (1) was publicly announced by a political subdivision, for the renovation of an urban area in its jurisdiction, (2) was either the subject of an agreement for development or a lease between such political subdivision and the primary developer of the project, or was undertaken pursuant to the political subdivision's grant of development rights to a primary developer-purchaser; (3) was identified as a single unitary project in the internal financing plans of the primary developer, and (4) is not substantially modified at any time after September 25, 1985. Properties described in the bill include six projects of a single primary developer, and a

seventh project that was the subject of a development agreement between a political subdivision and a bridge authority on December 19, 1984.

Federal Energy Regulatory Commission action

The requirements of the general binding contract rule will be treated as satisfied with respect to a project if, on or before September 25, 1985, the Federal Energy Regulatory Commission ("FERC") licensed the project or certified the project as a "qualifying facility" for purposes of the Public Utility Regulatory Policies Act of 1978. This rule will not apply if a FERC license or certification is substantially amended after September 25, 1985. On the other hand, minor modifications will not affect the application of this rule (e.g., technical changes in the description of a project, extension of the deadline for placing property in operation, changes in equipment or in the configuration of equipment).

Qualified solid waste disposal facilities

The bill does not apply to a qualified solid waste disposal facility if, before January 1, 1986, (1) there is a written binding contract between a service recipient and a service provider, providing for the operation of such facility and the payment for services to be provided by the facility, or (2) a service recipient, governmental unit, or any entity related to such an entity made a financial commitment of at least $200,000 to the financing or construction of the facility.

For purposes of this rule, a qualified solid waste disposal facility is a facility that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. This rule does not apply to replacement property. For example, assume a taxpayer/service provider enters into a long-term service contract before January 1, 1986, and a facility is initially placed in service after that date. Assume that the taxpayer finds it necessary to replace the facility 20 years later, pursuant to its obligation to provide continuing services under the pre-1986 service contract. The special rule will apply only to the first facility necessary to fulfill the taxpayer's obligations under the service contract.

Under a special rule applicable to the Tri-Cities Solid Waste Recovery Project (involving three cities in California), the rule for solid waste disposal facilities applies if the facility receives an authority to construct from the Environmental Protection Agency (or from its designee authorized to issue air quality permits under the Clean Water Act) before January 1, 1986.

For purposes of this provision, a contract is to be considered as binding notwithstanding the fact that the obligations of the parties are conditioned on factors such as the receipt of permits, satisfactory construction or performance of the facility, or the availability of acceptable financing.

A service recipient or governmental unit or a related party is to be treated as having made a substantial financial commitment to a facility if one or more entities have issued bonds or other obligations aggregating more than 10 percent of the anticipated capital

cost of such facility, the proceeds of which are identified as being for such facility or for a group of facilities that include the facility, or if one or more entities have expended in the aggregate at least $200,000 of their funds, or utilized or committed at least $200,000 of their assets, toward the development or financing of such facility. If a governmental entity acquires a site for a facility by purchase, option to purchase,[1] purchase contract, condemnation, or entering into an exchange of land, it shall be considered to have made a financial commitment equal to the fair market value of such site for purposes of this rule. For purposes of this provision, entities are related if they are described in section 168(i)(4)(A)(i).

Other exceptions

The bill does not apply to (1) those mass commuting vehicles exempted from the application of the tax-exempt leasing rules under DEFRA, (2) property described in section 216(b)(3) of TEFRA, or (3) a qualified lessee's automotive manufacturing property that was exempted from the deferral of the finance lease provisions under DEFRA. Property that qualifies under this transitional rule is also excepted from the requirements that investment credit claimed on transitional property be spread ratably over five years and that a full basis adjustment be made (discussed below).

The bill also provides other special transitional rules of limited application. Under the special rule for certain leasehold improvements placed in service by a lessee, the committee intends that the provision apply to property placed in service by the lessee or by the lessee's wholly-owned leasing subsidiary that is included in the lessee's affiliated group. Under the special rule for master plans for integrated projects, the committee intends that, (1) in the case of multi-step plans described in sec. 203(d)(5)(F) of the bill, the rule will include executive approval of a plan, if there has also been executive authorization of expenditures under the plan before September 26, 1985, and (2) in the case of single-step plans described in sec. 203(d)(5)(F) of the bill, the rule will include project-specific designs for which expenditures were incurred or committed before September 26, 1985.

Special rules applicable to the investment credit

Full basis adjustment

The bill requires a taxpayer to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of investment credits earned with respect to the property. The full-basis adjustment requirement also applies to credits claimed on qualified progress expenditures. Further, the full-basis adjustment requirement applies to all depreciable property, regardless of whether such property is eligible for ACRS. The lower basis will be used to compute depreciation deductions, as well as gain or loss on disposition of property.

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[1] In the case of an option to purchase, the committee intends the governmental entity to be treated as having made a financial commitment only if an amount is paid for the option and such consideration is forfeitable.

Normalization requirement for public utility property

The bill provides that if the tax benefits of previously allowed investment tax credits on public utility property are not normalized, then certain investment tax credits will be recaptured. In general, the amount recaptured is the greater of (1) all investment tax credits for open taxable years of the taxpayer or (2) unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not for open years), whichever is applicable. If such credits have not been utilized and are being carried forward, the carryforward amount is reduced in lieu of recapture. Similar principles apply to the failure to normalize the tax benefits of previously allowed employee stock ownership plan credits.

Five-year spread of credit on transition property

Only 20 percent of an investment credit earned on transition property is allowable in the first taxable year, and 20 percent of the credit is allowable in each of the four succeeding taxable years. This five-year spread of investment credits is required whether the taxpayer claims QPEs or claims the full credit for the year the property is placed in service. The full basis adjustment required by the bill occurs in the first taxable year, notwithstanding the five-year spread of the credit. If an investment credit is passed through to a lessee of property, the lessee must spread the credit over five years, and the lessor does not have to make the full basis adjustment. Instead, the lessee includes in income an amount equal to the allowable credit ratably over the ACRS recovery period for the property.

General treatment of QPEs

The repeal of the regular investment credit does not affect QPEs claimed with respect to the portion of the basis of any progress expenditure property attributable to progress expenditures for periods before January 1, 1986. After December 31, 1985, QPEs cannot be claimed unless it is reasonable to expect that the property will be placed in service before the applicable date. The determination of whether it is reasonable to expect that the placement-in-service requirement will be met is to be made on a year-by-year basis, beginning with the first taxable year that includes January 1, 1986. For any taxable year in which reasonable expectations change, no QPEs will be allowed, and previously claimed QPEs will be recaptured. Further, if the property is not placed in service on or before the last applicable date, post-1985 QPEs will be recaptured in the taxable year that includes such date.

Special rules for television and motion picture films

Special transitional rules apply to television and motion picture films for purposes of the investment credit (but not depreciation). For purposes of the general binding contract rule, (1) construction is treated as including production, (2) in accordance with industry practice, written contemporaneous evidence of a binding contract is treated as a written binding contract, and (3) in the case of any television film, a license agreement between a television network and a producer is treated as a binding contract to produce property. In

addition, a special rule is provided for certain films produced pursuant to a permanent financing arrangement described by the bill. For purposes of the placed-in-service requirement, films and sound recordings are treated as IDS Class 4 property.

Finance leases

The finance lease rules continue to apply to any transaction permitted by reason of section 12(c)(2) of DEFRA or section 209(d)(1)(B) of TEFRA.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $9,991 million in 1986, $20,704 million in 1987, $28,809 million in 1988, $36,761 million in 1989, and $49,905 million in 1990.

B. Limitation on General Business Credit (sec. 501(c)(4) of the bill and sec. 38 of the Code)

Present Law

The general business credit earned by a taxpayer can be used to reduce tax liability up to $25,000 plus 85 percent of tax liability in excess of $25,000. Unused credits for a taxable year may be carried back to each of the 3 taxable years preceding the unused credit year and then carried forward to each of the 15 following taxable years.

Reasons for Change

The 85 percent limit on the amount of tax which a taxpayer may offset with the investment credit enables corporations to reduce their tax liability to very low percentages of their taxable income and even lower percentages of their book income as reported to shareholders on financial statements. The Committee is concerned that this reduces confidence in the equity of the tax system.

Explanation of Provision

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the general business credit is reduced from 85 percent to 75 percent.[2]

Effective Date

This provision will apply to taxable years that begin after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $315 million in 1986, $454 million in 1987, $312 million in 1988, $163 million in 1989, and $67 million in 1990.

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[2] Additional limitations are imposed by section 501 of the bill in the case of taxpayers with tax preferences.

C. Rapid Amortization Provisions

1. Five-year Amortization of Trademark and Trade Name Expenditures (sec. 221 of the bill and sec. 177 of the Code)

Present Law

Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name.

Reasons for Change

Congress enacted the special amortization provision for trademark and trade name expenditures in 1956 in part because of a perception that certain large companies whose in-house legal staff handled trademark and trade name matters were able in some cases to deduct compensation with respect to these matters, because of difficulties of identification, while smaller companies that retained outside counsel were required to capitalize such expenses.[3] The committee does not believe that the possibility that some taxpayers may fail accurately to compute nondeductible expenses is a justification for permitting rapid amortization. Furthermore, to the extent such mischaracterization occurs, a five-year amortization provision only partially alleviates any unfairness. There is no basis for a presumption that a trademark or trade name will decline in value, or that investment in trademarks and trade names produces special social benefits that market forces might inadequately reflect. The committee believes that a tax incentive for trademark or trade name expenditures is therefore inappropriate.

Explanation of Provision

The election is repealed. Trademark and trade name expenditures will, therefore, be capitalized and generally recovered on disposition of the asset.

Effective Date

The repeal is effective for expenditures paid or incurred on or after January 1, 1986. However, present law will continue to apply to expenditures incurred (i) pursuant to a written contact that was binding as of September 25, 1985; or (ii) with respect to development, protection, expansion, registration or defense of trademarks or trade names commenced as of September 25, 1985, if the lesser

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[3] *See*, S. Rep. No. 1941, 84th Cong. 2d Sess., pp. 8-9 (1956).

of $1 million or 5 percent of the cost has been incurred or committed by that date; provided in each case the trademark or trade name is placed in service before January 1, 1988.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $3 million in 1986, $10 million in 1987, $22 million in 1988, $37 million in 1989, and $54 million in 1990.

2. Five-year Amortization of Pollution Control Facilities (sec. 222 of the bill and sec. 169 of the Code)

Present Law

Taxpayers may elect to amortize the cost of a certified pollution control facility over a 60-month period. To the extent that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, (i.e., is not included in amortizable basis) but must be recovered through depreciation.

In general, a certified pollution control facility is a treatment facility used to abate or control water or air pollution, in connection with a plant or other property that was in operation before January 1, 1976, if (1) the facility is certified by the appropriate authorities as meeting certain pollution control standards, (2) the facility does not significantly increase the output, extend the life, or reduce the operating costs of the plant or other property, and (3) the costs of the facility are not expected to be recovered over its useful life.

Reasons for Change

Amortization for pollution control facilities was enacted in 1969 in part to help industries to adjust to governmental standards restricting emitted pollutants. The committee believes that this purpose has largely been achieved and that the tax preference, because available only for certain approaches to pollution abatement, now distorts private decisions with respect to choosing the most effective or least expensive form of abatement. The election is available only for depreciable assets, and thus provides no incentive for other ways of reducing pollution from existing plants, such as using cleaner but more expensive grades of fuel and other raw material inputs. Similarly, availability of the election may discourage complete replacement of production technologies which generate considerable pollution in any event.

Explanation of Provision

The election is repealed. Expenditures for pollution control facilities will, therefore, be recovered in accordance with the applicable depreciation schedules.

Effective Date

The repeal is effective for expenditures paid or incurred on or after January 1, 1986. However, the 60-month amortization election will continue to apply to expenditures incurred for a certified pol-

lution control facility (i) pursuant to a written contract that was binding as of September 25, 1985; or (ii) with respect to facilities, construction of which is commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of the cost has been incurred or committed by that date; provided in each case the facility is placed in service before January 1, 1988. Expenditures that are not included in amortizable basis but must be recovered through depreciation will be recovered in accordance with the applicable depreciation transition rules under the bill.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by less than $5 million in each of the five years 1986 through 1990.

3. Five-year Amortization of Rehabilitation Expenses For Low-income Housing (sec. 223 of the bill and sec. 167(k) of the Code)

Present Law

Taxpayers may elect to amortize over a 5-year period certain qualifying expenditures for additions or improvements to low-income rental housing with a useful life of at least 5 years (other than hotels or other similar facilities primarily serving transients). Expenditures in any year for any dwelling unit are eligible only if the aggregate amount of expenditures for such unit exceeds $3,000 over two consecutive taxable years. Expenditures for any dwelling unit are generally not eligible to the extent that they aggregate more than $20,000 (in certain cases, $40,000).

Reasons for Change

The incentive for rehabilitation of low-income housing has been repeatedly extended since its original enactment, in order not to curtail additions or improvements to low-income projects. The committee recognizes the desirability of retaining a limited incentive for the rehabilitation of rental housing for very low-income tenants. The $20,000 per unit limit (an amount set in 1976) was increased to reflect increased construction costs.

Explanation of Provision

The committee bill eliminates the scheduled expiration of the amortization provision and establishes a $30,000 aggregate limit on expenditures per dwelling unit. As of the effective date, expenditures for units now subject to the $20,000 limit can be increased. The recapture rules of the bill applicable to low-income housing apply to the amortization deductions under this provision.

Effective Date

The modification to the aggregate limit will apply to permit additional expenditures over the present $20,000 limit, in the case of expenditures paid or incurred on or after January 1, 1986. The $40,000 limit will continue for expenses incurred (i) pursuant to a written contract that was binding as of September 25, 1985, or (ii)

with respect to rehabilitation commenced as of September 25, 1985, if 5 percent of the cost has been incurred or committed on that date, provided in each case the additions or improvements are placed in service before January 1, 1988. The $40,000 limit will also continue in certain other limited instances under a separate transition rule.

Revenue Effect

These provisions are estimated to decrease fiscal year budget receipts by a negligible amount in 1986, $2 million in 1987, $3 million in 1988, $13 million in 1989, and $22 million in 1990.

4. Fifty-year Amortization of Qualified Railroad Grading and Tunnel Bores (sec. 224 of the bill and sec. 185 of the Code)

Present Law

Domestic railroad common carriers may elect to amortize the cost of qualified railroad grading and tunnel bores over a 50-year period. Qualified railroad grading and tunnel bores include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

Reasons for Change

Congress enacted the special amortization provision for railroad grading and tunnel bore expenditures in 1969 to encourage investment in light of uncertainties about the useful life of such property. The scope of the provision was extended in 1976, to cover expenditures for pre-1969 property. The committee believes that continuation of the benefit is inconsistent with tax reform.

Explanation of Provision

The election is repealed. Expenditures for railroad grading and tunnel bores will, therefore, be capitalized and generally recovered on disposition of the asset.

Effective Date

The repeal is effective for expenditures paid or incurred on or after January 1, 1986. However, present law will continue to apply to expenditures incurred (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of the cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988. Under a separate rule, specified expenditures not reimbursed from insurance proceeds are treated as 5-year recovery property under ACRS. This treatment does not apply to such net unreimbursed expenditures in excess of $15 million.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by less than $5 million in each of the five years 1986 through 1990.

5. Expensing for Removal of Architectural Barriers to the Handicapped and Elderly (sec. 225 of the bill and sec. 190 of the Code)

Present Law

In general, present law allows electing taxpayers a tax incentive for the removal of architectural and transportation barriers to the handicapped and elderly (sec. 190). An electing taxpayer can treat certain expenses for the removal of architectural and transportation barriers as deductible expenses in the year paid or incurred instead of capitalizing them. Deductible expenses are those paid or incurred in order to make more accessible to and usable by the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in his trade or business. The maximum deduction for a taxpayer, including a controlled group of corporations filing a consolidated return, for any taxable year is $35,000.

This election is not available in taxable years beginning after December 31, 1985.

Reasons for Change

The committee believes it highly desirable to continue to promote the removal of these barriers, the social benefits of which may not be fully taken into account in private calculations of revenue and cost.

Explanation of Provision

The bill provides for a two-year extension (to taxable years beginning before January 1, 1988) of the present-law provision that allows the expensing of costs attributable to the removal of architectural and transportation barriers to the handicapped and elderly.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $9 million in 1986, $17 million in 1987, $8 million in 1988, and less than $5 million in 1989.

D. Other Capital-Related Costs

1. Amendments Relating to Credit for Increasing Research Expenditures (Sec. 231 of the bill and sec. 30 of the Code)

Present Law

Expensing

A taxpayer may elect to deduct currently the amount of research and experimental expenditures incurred in connection with its trade or business (sec. 174), notwithstanding the general rule that business expenditures to develop or create an asset which has a useful life extending beyond the taxable year must be capitalized. (Alternatively, the taxpayer may treat these expenditures as deferred expenses and deduct them over a period of not less than 60 months on a straight-line basis.) This provision was enacted in the 1954 Code in order to eliminate the need to distinguish research from business expenses for deduction purposes, and to encourage taxpayers to carry on research and experimentation activities.[1]

The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election, except to exclude certain costs. Treasury regulations (sec. 1.174-2(a)) define "research or experimental expenditures" to mean "research and development costs in the experimental or laboratory sense." The regulations provide that this includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned." Other research or development costs—i.e., research or developments costs not "in the experimental or laboratory sense"—do not qualify under section 174.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

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[1] H. Rpt. No. 1337, 83d Cong., 2d Sess. at 28 (1954); S. Rpt. 1622, 83d Cong., 2d Sess. at 33 (1954); *Snow* v. *Comm'r*, 416 U.S. 500 (1974) (citing Congressional intent to encourage research by both "oncoming" and "ongoing" businesses); *Green* v. *Comm'r*, 83 T.C. 667 (1984) (intent of sec. 174 was to encourage "up-and-coming" small businesses to engage in research, not to allow passive investor entities to obtain current deductions).

Incremental tax credit

Under a provision enacted in the Economic Recovery Tax Act of 1981, the taxpayer also may claim a nonrefundable 25-percent income tax credit for certain research expenditures paid or incurred in carrying on an existing trade or business (sec. 30). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). Under present law, the credit will not be available for expenses paid or incurred after December 31, 1985.

Research expenditures eligible for the incremental credit consist of (1) in-house expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The credit provision adopts the definition of research used for purposes of the section 174 expensing provision, but subject to three exclusions: (1) expenditures for research which is conducted outside the United States; (2) research in the social sciences or humanities; and (3) research to the extent that it is funded by any grant, contract, or otherwise by another person (or any governmental entity).

Under present law, the incremental research credit is not subject to the general limitation on use of business credits (85% of tax liability over $25,000).

Reasons for Change

Three-year extension, reduction in rate of credit.—When the incremental research credit was enacted in 1981, the Congress expressed serious concern about the then substantial relative decline in total U.S. expenditures for research and experimentation. The purpose of enacting the credit was to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. An expiration date for the credit was deemed desirable in order to enable the Congress to evaluate the operation of the credit, and to determine whether it should be extended and what modifications would be necessary to make the credit more effective.

The committee believes that an additional three-year extension of the credit is desirable in order to obtain sufficient data and information to evaluate whether or not the credit should be further extended or made permanent. In the context of other tax reform provisions of the bill, and the continued allowance of full expensing of research expenditures, the committee bill reduces the credit rate to 20 percent.

Eligibility of rental costs.—Under present law, expenditures for renting research equipment are eligible for the credit, but deprecia-

tion allowances for purchased research equipment are not eligible. The committee believes that this inconsistent treatment is not desirable, and that the taxpayer's investment decision to purchase or lease should not be skewed by the credit provisions. The committee bill makes such rental costs, etc. ineligible for the credit, except for certain payments by the taxpayer to another person for the use of computer time in research.

Credit use limitation.—The committee believes that the general limitation on use of business credits (under the bill, 75 percent of tax liability over $25,000) should apply to the research credit.

Clarification and modification of research definition for credit purposes.—After reviewing available information and testimony on the actual use of the credit to date, the committee believes that it should clarify and modify the definition of qualified research expenses for purposes of the credit. The committee believes that the definition has been applied too broadly in practice, and some taxpayers have claimed the credit for virtually any expenses relating to product development. According to early data on the credit, the Treasury has reported, many of these taxpayers are in industries that do not involve high technology or its application in developing technologically new and improved products or methods of production.

Because the committee bill amends present law to extend the research credit for an additional three years, the committee concluded that it was appropriate and desirable to provide more explicit guidance as to the scope of the term "qualified research" as used in the credit provision. Accordingly, the committee decision clarifies the distinction between research expenditures and certain nonresearch activities (post-research activities, adaptation, and surveys and studies). Also, the committee decision targets the extended credit to research undertaken for the purpose of discovering information which is (1) technological in nature and (2) intended to result in a new or improved item for sale or use in the taxpayer's trade or business. In addition, research will be eligible for the extended credit only where substantially all the activities undertaken in developing or improving the business item constitute elements of a process of experimentation relating to functional aspects of the business item. Finally, the committee decision will limit allowance of the credit for the costs of developing internal-use software to such software meeting a high threshold of innovation. No inference is intended from these rules as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

University basic research.—The committee believes it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research where such expenditures do not merely represent a switching of donations from general university giving and where certain other maintenance-of-effort levels are exceeded.

Explanation of Provision

Three-year extension, reduction in rate of incremental credit

The bill extends the incremental research tax credit for three additional years, i.e., for qualified research expenditures paid or incurred through December 31, 1988, at a credit rate of 20 percent.

Eligibility of rental costs

The bill generally repeals the present-law provision treating amounts paid for the right to use personal property in qualified research as eligible for the credit, but continues credit eligibility for amounts paid by the taxpayer to another person for the use of computer time in the conduct of qualified research. The latter provision is intended to benefit smaller businesses which cannot afford to purchase or lease their own computers for research purposes, and hence is intended to apply where the taxpayer is not the principal user of the computer. Consistently with the present-law limitations on credit-eligibility of rental costs, computer-use payments are not eligible for the credit to the extent that the taxpayer (or a person with which the taxpayer must aggregate expenditures in computing the credit) receives or accrues any amount from any other person for computer use.

In computing the research credit for a taxable year beginning after 1985 (when rental costs will not be eligible for the credit), a taxpayer may exclude from the base-period amount with respect to such year any rental costs, etc. (other than for computer-use costs of a type remaining eligible for the credit in post-1985 years) that were allowable as qualified research expenses under section 30(b)(2)(A)(iii) (as then in effect) in a base-period year.

Clarification and modification of research definition for credit purposes

Clarification of nonresearch activities

The committee intends to clarify that the following nonresearch activities cannot qualify for the incremental research credit.

Post-research activities.—Activities with respect to a business item after the beginning of commercial production cannot qualify as qualified research. Thus, no expenditures relating to a business item are eligible for the credit after the item has been developed to the point where it either meets the basic functional and economic requirements of the taxpayer for such item, or is ready for commercial sale or use. For example, the credit is not available for such expenditures as the costs of preproduction planning for a finished business item, "tooling-up" for production, trial production runs, "trouble-shooting" involving detecting faults in production equipment or processes, accumulation of data relating to production processes, and the cost of "debugging" product flaws. The costs of any development of plant processes, machinery, or techniques for commercial production of a business item do not constitute qualified research. However, qualified research to develop a technologically new or improved manufacturing process, etc., may qualify for the credit.

By way of further illustration, the credit is not available for costs of additional clinical testing of a pharmaceutical product after the product is made commercially available to the general public. However, the clinical testing in the United States of a product prior to production for sale in this country, or clinical testing seeking to establish new functional uses, characteristics, combinations, dosages, or delivery forms as improvements to an existing product, is eligible for the credit. Thus, for example, testing a drug presently used to treat hypertension for a new anti-cancer application would be eligible. Similarly, testing an antibiotic in combination with a steroid to determine its therapeutic value as a potential new anti-inflammatory drug would be eligible for the credit.

Adaptation.—Adaptation of an existing business item to a particular requirement or customer's need as part of a continuing commercial activity does not constitute an activity for which the credit is intended to be available. Thus, for example, the costs of modifying an existing computer software item for a particular customer are not eligible for the credit. However, the mere fact that an item is intended for a specific customer does not disqualify otherwise qualified research costs of the item (assuming that the research is not funded by the customer).

Surveys, etc..—The credit is not intended to be available for the costs of efficiency surveys, management studies, management techniques, market research, market testing and development (such as advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control. Management techniques include such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

Modification of credit-eligible research definition

In extending the incremental research credit for an additional three years, the committee intends to limit the credit to research activities designed to produce technologically new or improved business items, where substantially all the taxpayer's activities in developing or improving the item constitute elements of a process of experimentation relating to functional aspects of the business item.

Technological characteristics.—The determination of whether new or improved characteristics of a business item are technological in nature depends on whether the process of experimentation to develop or improve such characteristics fundamentally relies on principles of the physical or biological sciences, engineering, or computer science—in which case the characteristics are deemed technological—or on other principles, such as those of economics—in which case the characteristics are not to be treated as technological. For example, new or improved characteristics of financial services or similar products (such as new types of variable annuities or legal forms) or advertising do not qualify as technological in nature.

Process of experimentation.—The concept of "process of experimentation" means a process of scientific experimentation or engi-

neering activities to design a business item where the design of the item as a whole is uncertain at the outset, but instead must be determined by developing one or more hypotheses for specific design decisions, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall item.

Thus, for example, costs of developing a new or improved business item are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.

A business item will not be considered as developed through a process of experimentation if the predominant portion of the development activity consists of duplication, i.e., the reproduction of an existing business item of another person from a physical examination of the item itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such item.

Functional aspects.—Activities relating to a new or improved function, performance, reliability, quality, or significantly reduced costs, or such similar factors as set forth in Treasury regulations, may constitute qualified experimentation. Activities undertaken to assure achievement of the intended function, performance, etc. of the business item after the beginning of commercial production of the item do not constitute qualified experimentation. In addition, activities relating to style, taste, cosmetic, or seasonal design factors do not constitute qualified experimentation.

Application of tests.—The term business item means a product, process, computer software, technique, formula, or invention to be offered for sale, lease, or license, or used by the taxpayer in a trade or business. If all aspects of the "technologically new or improved" requirement described above are not met with respect to a product, etc. but are met with respect to one or more elements thereof, the term business item means the most significant set of elements of such product, etc. with respect to which all aspects of the requirement are met.

Thus, the "technologically new or improved" requirement is applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of that requirement are not met at that level, the test applies at the most significant subset of elements of the product, etc. This "shrinking back" of the product is to continue until either a subset of elements of the product that

satisfies the requirement is reached, or the most basic element of the product is reached and such element fails to satisfy the test.

Internal-use computer software

Under the committee modification, the research credit will not be available for the costs of routine development of computer software for the taxpayer's own internal use (e.g., for payroll, bookkeeping, or personnel management functions). The development of computer software will not be considered routine only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements just stated).

Effect on section 174 definition

No inference is intended from the above definitional rules as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

University basic research credit

In general

Under present law, research expenditures entering into the computation of the incremental research credit include 65 percent of a corporation's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations. Under the bill, a 20-percent tax credit applies to the *excess* of (1) 100 percent of corporate cash expenditures for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.[2]

Qualifying expenditures

For purposes of credit, qualifying basic research expenditures are cash expenditures paid pursuant to a written agreement between the taxpayer corporation[3] and a university or certain other qualified organizations for basic research to be performed by the qualified organization (or by universities receiving funds through the

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[2] The bill provides a single research credit, consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this report generally refers to these components as the incremental research credit and the university basic research credit.

[3] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

initial recipient qualified organizations). Such corporate expenditures for university basic research are deemed to satisfy the trade or business test for the research credit, whether or not the basic research is in the same field as an existing trade or business of the corporation.

Under the bill, qualifying expenditures include both grants or contributions by the corporation that constitute charitable contributions under section 170, and also payments for contract research to be performed by the qualified organization on behalf of the corporation. Such expenditures are not eligible for a credit unless and until actually paid by the corporation to a qualified organization. Thus, an accrual-basis corporation may not claim the credit for amounts incurred, but not actually paid, for university basic research.

Under the bill, only cash payments may qualify as a basic research payment. No amount (basis or value) on account of contributions or transfers of property is eligible for either the incremental credit or the basic research credit, whether or not such property constitutes scientific equipment eligible for an augmented charitable deduction under section 170(e)(4).

As under present law, the term "basic research" is defined in the bill as any original investigation for the advancement of scientific knowledge not having a specific commercial objective, other than basic research in the social sciences, arts, or humanities or basic research conducted outside the United States.

Qualified organizations

To be eligible for a credit, the corporate expenditures must be for basic research to be conducted by a qualified organization. For this purpose, the term qualified organization generally includes colleges or universities, tax-exempt scientific research organizations, and certain tax-exempt conduit or grant organizations.

The first category of qualified organizations consists of educational institutions that both are described in section 170(b)(1)(A)(ii) and constitute institutions of higher education within the meaning of section 3304(f). The second category consists of tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations. Also, certain tax-exempt grant funds that qualify under present law continue to qualify under the bill.

In addition, the bill treats as qualified any tax-exempt organization that is organized and operated primarily to promote scientific research by colleges or universities pursuant to written research agreements, that expends on a current basis substantially all its funds (or all the basic research payments received by it) through grants and contracts for basic research by colleges and universities, and that is either (a) described in section 501(c)(3) and is not a private foundation or (b) described in section 501(c)(6) (trade associations).

Computation rules for revised basic research credit

The university basic research credit applies to the *excess* of (1) 100 percent of corporate cash expenditures for basic research *over* (2) the sum of the minimum basic research amount plus the maintenance-of-effort amount.

The minimum basic research amount is the *greater* of two fixed floors—

(a) the average of all credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983; *or*

(b) one percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983.

In the case of a corporation that was not in existence for at least one full year of the three taxable years in the fixed base period, the bill provides that the minimum basic research amount for the base period shall not be less than 50 percent of the basic research payments for the current taxable year. If the corporation was in existence for one or two of the base-period years, the fixed floor is to be computed with respect to such year or years.

The maintenance-of-effort amount is the *excess* of (1) the average of the nondesignated university donations paid or incurred by the taxpayer during the three taxable years immediately preceding the taxable year beginning after December 31, 1983, as adjusted under the bill to reflect inflation, *over* the amount of nondesignated university donations paid by the taxpayer in the taxable year. The term "nondesignated university donation" means all amounts paid by the taxpayer to all colleges or universities for which a charitable deduction was allowable and that were not taken into account in computing the research credit.

The amount of credit-eligible basic research expenditures to which the new credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the new credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Credit limitations

The bill makes the research credit subject to the general business credit limitation, as amended by the bill.

Effective Date

The amendments to the credit (including the modifications to the definition of qualified research) made by the provision are effective for taxable years beginning after December 31, 1985. Under the provision, the credit will not apply to amounts paid or incurred after December 31, 1988.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $474 million in 1986, $974 million in 1987, $1,199 million in 1988, $868 million in 1989, and $466 million in 1990.

2. Augmented Charitable Deduction for Certain Donations of Scientific Equipment (Sec. 231(f) of the bill and sec. 170(e)(4) of the Code)

Present Law

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain that the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)). Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)).

Reasons for Change

The committee believes that the present-law provisions concerning donations of newly manufactured scientific equipment to universities for research use should be extended to include such donations to tax-exempt scientific research organizations.

Explanation of Provision

Under the bill, the category of eligible donees under section 170(e)(4) is expanded to include tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The revenue effect of this provision is included with the revenue effect for item 1, above.

3. Tax Credit for Rehabilitation Expenditures (Sec. 232 of the bill and secs. 46(b), 48(g), and 48(q) of the Code)

Present Law

A three-tier investment tax credit is provided for qualified rehabilitation expenditures. The credit is 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures (including residential buildings). A certified historic structure

is defined as a building (and its structural components) that is listed in the National Register of Historic Places, or is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

The rehabilitation credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. If the 15- or 20-percent investment credit is allowed for qualified rehabilitation expenditures, the basis of the property is reduced by the amount of credit earned (and the reduced basis is used to compute cost recovery deductions) (sec. 48(q)(1) and (3)). The basis is reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of certified historic structures.

Qualified rehabilitation expenditures are eligible for the credit only if incurred in connection with a substantial rehabilitation that satisfies an external-walls requirement. The test of substantial rehabilitation generally is met if the qualified expenditures during a 24-month measuring period exceed the greater of the adjusted basis of the building as of the first day of the 24-month period, or $5,000. (In phased rehabilitations, the 24-month measuring period is extended to 60 months.)

The external-walls requirement provides generally that at least 75 percent of the existing external walls of the building must be retained in place as external walls in the rehabilitation process. An alternative test provides that the external-walls requirement is met if (1) at least 75 percent of the external walls are retained in place as either internal or external walls, (2) at least 50 percent of such walls are retained in place as external walls, and (3) at least 75 percent of the building's internal structural framework is retained in place.

In the case of rehabilitations of certified historic structures, certain additional rules apply. In particular, the Secretary of the Interior must certify that the rehabilitation is consistent with the historic character of the building or the historic district in which the building is located. In fulfilling this statutory mandate, the Secretary of the Interior's Standards for Rehabilitation are applied. *See* 36 CFR Part 67.7 (March 12, 1984).

Qualified rehabilitation expenditures generally include any amounts properly chargeable to capital account of a building in connection with a rehabilitation, but do not include the following:

(1) the cost of acquiring a building or an interest in a building (such as a leasehold interest);

(2) the cost of facilities related to a building (such as a parking lot); and

(3) the cost of enlarging an existing building.

Lessees are entitled to the credit for qualified expenditures incurred by the lessee if, on the date the rehabilitation is completed, the remaining lease term (without regard to renewal periods) is at least as long as the applicable recovery period (generally 19 years; 15 years in the case of low-income housing). Under regulations prescribed by the Secretary of the Treasury, the substantial rehabilitation test for a lessee is generally applied by comparing the lessee's qualified rehabilitation expenditures to the lessor's adjusted basis in the building (i.e., the lessee steps into the shoes of the lessor).

The rehabilitation credit is subject to recapture if the rehabilitated building is disposed of or otherwise ceases to be qualified investment credit property with respect to the taxpayer during the five years following the date the property is placed in service. If the Department of the Interior decertifies a rehabilitation of a certified historic structure during the recapture period, the property ceases to be qualified investment credit property.

Reasons for Change

In 1981, Congress restructured and increased the tax credit for rehabilitation expenditures. Congress was concerned that the tax incentives provided to investments in new structures (e.g., accelerated cost recovery) would have the undesirable effect of reducing the relative attractiveness of the prior-law incentives to rehabilitate and modernize older structures, and might lead investors to neglect older structures and relocate their businesses.

The committee has concluded the incentives granted to rehabilitations in 1981 remain justified. The committee believes that such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. Additionally, a tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

The committee also sought to focus the credit particularly on historic and certain older buildings and to ensure that the credits accomplish their intended objectives of preserving such historic and older buildings. In addition, the committee was concerned that the existing credit percentages would be too high in the context of the lower overall rates provided in the bill. For example, the 25-percent credit in present law offsets 50 cents of income for every $1 of rehabilitation expenditures made by a taxpayer in the top 50-percent bracket. A credit of 19 percent would accomplish the same offset to income with a top bracket of 38 percent. Similarly reduced credits would reproduce the same offsets to income as the current 15-percent and 20-percent rehabilitation credits.

Explanation of Provision

Two-tier credit

The committee bill replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than certified historic structures) originally placed in service before 1936.

Retention of certain rules

As under present law, the 10-percent credit for the rehabilitation of buildings that are not certified historic structures is limited to nonresidential buildings, but the 20-percent credit for rehabilitation of historic buildings is available for both residential and nonresidential buildings.

The present law provisions that determine whether rehabilitation expenditures qualify for the credit were generally retained in the bill. In general, no changes were made regarding the substantial rehabilitation test, the specific types of expenditures that do not qualify for the credit, the provisions applicable to certified historic structures and tax-exempt use property, or the recapture rules. No expenditure would be eligible for credit unless the taxpayer elects to recover the costs of the rehabilitation using the straight-line method of depreciation.Further, expenditures incurred by a lessee would not qualify for the credit unless the remaining lease term, on the date the rehabilitation is completed, is at least as long as the applicable recovery period under the incentive depreciation system (generally 30 years; 20 years for very low-income housing).

External-walls requirement

The external-walls requirement was significantly modified by the bill. The existing provision that requires 75 percent of the existing external walls to be retained in place as external walls was deleted and replaced by the alternative test provided in present law that requires the retention in place of (1) at least 75 percent of the existing external walls (including at least 50 percent as external walls) as well as (2) at least 75 percent of the building's internal structural framework. Thus, unlike the situation that can occur under present law, a building that is completely gutted cannot qualify for the rehabilitation credit under the committee bill. In general, a building's internal structural framework includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

Because the committee believes that the Secretary of the Interior's Standards for Rehabilitation ensure that certified historic structures are properly rehabilitated, the external-walls requirement for such buildings was deleted by the bill in order to provide the Secretary of the Interior with appropriate flexibilty. The committee intends, however, that rehabilitations eligible for the 20-percent credit should continue to be true rehabilitations and not substantially new construction. The committee expects, therefore, that the Secretary of the Interior will continue generally to deny certification to rehabilitations during which less than 75 percent of the external walls are not retained in place.

Basis reduction

The bill deletes the limited exception in current law that requires a basis reduction for only 50 percent of the credit in the case of certified historic structures. Thus, a full basis adjustment is required for both the ten-percent and 20-percent rehabilitation credits.

Effective Date

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1985.

A general transitional rule provides that the modifications to the rehabilitation credit (other than certain reductions in the credit percentage—see below) will not apply to property placed in service before January 1, 1994, if the property is placed in service (as rehabilitation property) as part of either a rehabilitation completed pursuant to a written contract that was binding (under applicable state law) on September 25, 1985. This rule also applies to a rehabilitation with respect to property (including any leasehold interest) that was acquired before September 26, 1985, or was acquired on or after such date pursuant to a written contract that was binding on September 25, 1985, if (1) the rehabilitation was completed pursuant to a written contract that was binding on November 22, 1985, parts 1 (if necessary) and 2 of the Historic Preservation Certification Application were filed with the Department of the Interior (or its designee) before November 23, 1985, or (2) the lesser of $1,000,000 or five percent of the cost of the rehabilitation (including only qualified rehabilitation expenditures) is incurred before November 23, 1985, or is required to be incurred pursuant to a written contract that was binding on November 22, 1985. The committee intends the transitional rules described above to apply to all of the individual components of a single project involving the rehabilitation of over 60 individual buildings listed on the National Register at the Franford Arsenal; therefore, the commencement of construction or execution of a binding contract before the relevant date as to buildings included in the project will qualify the entire project.

The modifications to the rehabilitation credit also do not apply to any property placed in service as part of a rehabilitation if an urban development action grant was first approved on September 30, 1983, with respect to such rehabilitation, such grant was further amended and approved by the Department of Housing and Urban Development on December 14, 1984, and there was a binding contract with a municipality as of February 15, 1985.

Further, modifications do not apply to the following specific rehabilitation projects: the rehabilitation of eight bathhouses within the Hot Springs National Park or of buildings in the Central Avenue Historic District adjacent to such Park, any rehabilitation conducted pursuant to Public Law 97-125, the rehabilitation of Union Station in Indianapolis, Indiana, and the rehabilitation of the Upper Pontalba Building in New Orleans, Louisiana.

If a taxpayer transfers his rights in property under rehabilitation or under a binding contract to another taxpayer, the modifications do not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1(B), the partnership is to be treated as having transferred its rights in the property under rehabilitation or the binding contract to the new partnership.

If property that qualifies under any of the foregoing transitional rules is placed in service after December 31, 1985, the applicable credit percentages are reduced from 25, 20, and 15 to 20, 13, and ten, respectively, and a full basis adjustment in required.

Property that qualifies for transitional relief under one of the rules described above is also excepted from the depreciation changes made by section 201 of the bill.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $32 million in 1986, $211 million in 1987, $522 million in 1988, $797 million in 1989, and $1,046 million in 1990.

4. Merchant Marine Capital Construction Fund (Sec. 13 of the bill and new sec. 7518)

Present Law

The Merchant Marine Act of 1936

The Merchant Marine Act of 1936, as amended, provides federal income tax incentives for U.S. taxpayers who own or lease vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries; these provisions are not contained in the Internal Revenue Code of 1954.

In general, qualified taxpayers are entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. Earnings from the investment or reinvestment of amounts in a capital construction fund are excluded from income.

The tax treatment of a withdrawal from a capital construction fund depends on whether it is "qualified." A nonqualified withdrawal of previously deducted or excluded monies by a taxpayer from a fund will generate income to the taxpayer. A qualified withdrawal does not generate income to the taxpayer. A qualified withdrawal is a withdrawal for the acquisition, construction, or reconstruction of a qualified vessel, or for the payment of principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of such a vessel. A qualified vessel is a vessel (including barges and containers) constructed or reconstructed in the United States, documented under U.S. laws, and which is to be operated in the U.S., foreign, Great Lakes, or noncontiguous domestic trade, or in U.S. fisheries.

A nonqualified withdrawal of previously deducted or excluded monies from a fund will generate income to the taxpayer. In addition, interest on the tax liability attributable to a nonqualified withdrawal is payable from the date of deposit.

Capital cost recovery

Because provision is made for the deduction (or exclusion) of certain amounts deposited in a capital construction fund and their tax-free withdrawal in the case of a qualified withdrawal, the amount of funds withdrawn reduces the tax basis of the qualified vessel. This provision is designed to prevent double deductions, which would occur if a taxpayer was permitted to take depreciation deductions for amounts the taxpayer had already deducted from—or never included in—income.

Investment tax credit

In general, the amount of investment tax credit for eligible property is determined with reference to the basis. A taxpayer may compute the investment tax credit for a qualified vessel (i.e., one that was financed in whole or in part by qualified withdrawals from a capital construction fund) by including at least one-half of qualified withdrawals in basis.

Reasons for Change

The committee believes that the provision of tax benefits for U.S. shipping through the Capital Construction Fund mechanism is appropriate. Aid U.S. shipping industries is necessary to assure an adequate supply of ships in the event of war. Congress has adhered to a policy of providing tax incentives to the domestic shipping industry for many years, and the committee was concerned that the elimination of such incentives, coupled with reduced appropriations for maritime construction, could injure the industry. The incentive under present law may not function properly as an incentive for U.S. shipbuilding. Consequently, committee determined that additional requirements should be imposed to insure that capital construction funds are used for the intended purpose. The Committee was also concerned about the ability of taxpayers to avoid taxation on nonqualified withdrawals by making such withdrawals in years for which there are net operating losses (or other tax attributes that reduce the tax attributable to the withdrawal).

The committee became aware during its tax reform hearings that Treasury's proposal to terminate the Capital Construction Fund (CCF) could have a serious adverse impact on the financial reporting requirements of CCF holders. The committee intends that its modifications to the CCF program be viewed as not requiring any change in the financial statement presentation of income taxes by CCF holders. This will allow these taxpayers to provide future financial statements necessary for ship financing on a basis consistent with that anticipated at the time these taxpayers entered into CCF agreements with the Federal government.

Explanation of Provision

The bill coordinates the application of the Internal Revenue Code of 1985 with the capital construction fund program of the Merchant Marine Act of 1936, as amended. In addition, new requirements are imposed, relating to (1) the tax treatment of nonqualified withdrawals, (2) certain reports to be made by the Secretaries of Transportation and Commerce to the Secretary of the Treasury, and (3) a time limit on the amount of time monies could remain in a fund without being withdrawn for a qualified purpose.

For purposes of the definition of the term "qualified withdrawals," under new section 7518(e) (sec. 607(f) of the Merchant Marine Act, 1936), the committee intends the phrase, "acquisition, construction, or reconstruction of a qualified vessel" to be interpreted as including acquisition through either purchase or lease of an agreement vessel for a period of five years or more. This interpretation parallels the structure of: (1) the scope of eligibility to estab-

lish a capital construction fund under sec. 607(a) of the Merchant Marine Act, 1936 (which permits deposits into a CCF fund by either an owner/lessor or the lessee of an eligible vessel, or both, subject to certain limitations), and (2) the scope of qualified withdrawals for vessel acquisition through either purchase (in the form of a downpayment toward the purchase price) or payment of long-term indebtedness on an agreement vessel. This interpretation is also consistent with current industry acquisition practices reflecting a long-term trend toward vessel acquisition through lease rather than purchase.

Inclusion in Internal Revenue Code

The tax provisions relating to capital construction funds are recodified as part of the Internal Revenue Code of 1985. For purposes of the Internal Revenue Code of 1985, defined terms shall have the meaning given such terms in the Merchant Marine Act of 1936, as amended, as in effect, on the date of enactment of the bill.

Tax treatment of nonqualified withdrawals

The maximum rate of tax (36 percent for corporations and 38 percent for individuals) is to be imposed on nonqualified withdrawals made after December 31, 1985; This penalty is in addition to interest payable from the date the amount withdrawn was reported.

If a taxpayer makes a nonqualified withdrawal out of a capital construction fund, the income tax payable by the taxpayer for the year of withdrawal is generally to be increased by such amount as is necessary to assure that the tax liability with respect to the nonqualified withdrawal is determined by reference to the top marginal tax rates applicable to ordinary income and capital gains. Special rules are provided to limit the application of this provision in cases where the taxpayer derived no tax benefit from depositing the funds.

Capital construction fund reports to Treasury

The Secretary of Transportation and the Secretary of Commerce are required to certify to the Secretary of Treasury that the monies in a fund are appropriate for vessel construction requirements. If it is determined that the fund balances exceed what is appropriate to meet vessel construction program objectives, the fundholder would be required to develop appropriate program objectives within three years or treat the excess as a nonqualified withdrawal.

Ten-year limit on deposits

The bill imposes a ten-year limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose. This rule applies to all deposits, including those made before the general effective date. The ten-year period begins to run on the later of the date of deposit or January 1, 1986.

Monies that are not withdrawn after a ten-year period—other than amounts that have been committed to the construction or acquisition of identified vessels pursuant to contracts that are binding as of the last day of the ten-year period—are to be treated as nonqualified withdrawals, according to the following schedule: for the eleventh year, the fundholder would be treated as having with-

drawn 20 percent; for the twelfth year, 40 percent; for the thirteenth year, 60 percent; for the fourteenth year, 80 percent, and for the fifteenth year, 100 percent. For purposes of this rule, if a taxpayer enters into a binding contract before the close of a taxable year, the amount so committed is not treated as remaining in the fund.

Effective Date

The bill is effective for taxable years beginning after December 31, 1985.

The following is an exchange of correspondence between the Chairman of the Committee on Ways and Means and the Committee on Merchant Marine and Fisheries concerning this provision of the bill.

DECEMBER 3, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: Pursuant to our earlier conversation, I have reviewed the provisions of H.R. 3838, the Tax Reform Act of 1985, which have an impact on the Capital Construction Fund program. It is certainly an accomplishment for which I sincerely congratulate you, and I take this opportunity to express my gratitude for the cooperation between our committees. As you know, several members of my committee testified before you on the matters contained within the Capital Construction Fund. Their testimony was reflective of the position on the tax effects of the Capital Construction Fund program adopted by the Committee on Merchant Marine and Fisheries. As you well know, the retention of this most valuable capital appreciation provision was, and still is, of the utmost importance, not only to this committee but more importantly to the maritime promotional program of which the Capital Construction Fund is only one part.

It is therefore most gratifying that you have agreed not only to retain the Capital Construction Fund, but also that you have agreed that the Capital Construction Fund should not be treated apart from the other promotional elements in the Merchant Marine Act, 1936. At the same time, we certainly understand and agree with the positioning, in parallel, of certain portions of this program in the Internal Revenue Code.

I appreciate our understanding that my Committee's cooperation in expediting key tax reform legislation in no way prejudices any of its jurisdictional rights regarding the Capital Construction Fund under section 1(n) of House Rule X.

In the future there should be no difficulty in our committees cooperating fully when considering amendments to the Capital Construction Fund program whether the amendments are to section 7518 of the Internal Revenue Code or to section 607 of the Merchant Marine Act, 1936. I am certain that consideration by our committees of legislation dealing with either section 607 of the Merchant Marine Act, 1936, or section 7518 of the Internal Revenue Code will be conducted in the spirit of cooperation that existed

during the pendency of consideration of the Tax Reform Bill, and further that neither committee will utilize any device to frustrate the consideration by the House of Representatives of any measure that may be referred jointly to the Committee on Merchant Marine and Fisheries and the Committee on Ways and Means.

Once again, Mr. Chairman, please accept my sincere gratitude for the way in which our committees functioned in developing the legislative changes which will, I am certain, be beneficial to both sound tax policy and sound maritime policy.

Sincerely,

WALTER B. JONES, *Chairman.*

DECEMBER 4, 1985.

Hon. WALTER B. JONES,
Chairman, Committee on Merchant Marine and Fisheries,
U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: Thank you for your letter of December 3, regarding your review of provisions of H.R. 3838, the Tax Reform Act of 1985, which embodies the new Internal Revenue Code of 1985.

As you know, contained within this legislation are provisions dealing with the Capital Construction Fund, a promotional program designed to encourage the investment of capital in the construction of merchant vessels in United States shipyards. As you stated, with your Committee's concurrence, certain conforming amendments were added to harmonize amendments proposed by the Committee on Ways and Means to these Capital Construction Fund provisions with the Merchant Marine Act, 1936. Again with your concurrence, the conforming amendments amended section 607 of the Merchant Marine Act, 1936, to reflect these changes. These changes are very similar to changes in legislation (H.R. 3164) that have been before your committee. In addition, a new section 7518 has been added to the Internal Revenue Code to reflect those provisions of the Capital Construction Fund that have direct tax policy or tax administration effect. I appreciate the cooperation of the Committee on Merchant Marine and Fisheries in achieving what I view to be a most acceptable result.

By cooperating with the Committee on Ways and Means in this effort, the Committee on Merchant Marine and Fisheries has aided the process of bringing key tax legislation to the House floor promptly without in any way prejudicing its jurisdictional rights regarding the Capital Construction Fund under section 1(n) of House Rule X.

As in this intance, I have every expectation that our committees will continue to cooperate fully when considering amendments to the Capital Construction Fund program whether the amendments are to section 7518 of the Internal Revenue Code or to section 607 of the Merchant Marine Act, 1936. In this way both tax policy and maritime policy will be well served by the committees of Congress charged with their development and oversight.

Once again, Mr. Chairman, let me express my thanks for your support in this most difficult but worthwhile effort.

Sincerely,

DAN ROSTENKOWSKI, *Chairman.*

Revenue Effects

The bill is expected to increase fiscal year budget receipts by $3 million in 1986, $5 million in 1987, $4 million in 1988, $4 million in 1989, and $4 million in 1990.

E. Capital Gains and Losses

1. Individual Long-Term Gains (sec. 241 of the bill and sec. 1202 of the Code)

Present Law

Individual and other noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. As a result, the highest tax rate applicable to a noncorporate taxpayer's net capital gain is 20 percent (the 50-percent maximum individual tax rate times the 40 percent of net capital gain included in adjusted gross income).

This deduction is included in the minimum tax base as a preference. However, since the alternative minimum tax rate is 20 percent, the alternative minimum tax does not increase the maximum Federal income tax rate on net capital gains alone.

Reasons for Change

Reduced rates on long-term capital gains of individuals have historically been viewed as alleviating the impact of high individual tax rates on dispositions of assets that have appreciated in value over time. The reduced rates may contribute to the efficient allocation of capital by minimizing the possible "lock-in" effect of higher regular rates, and may also serve as an incentive to investment.

The committee believes it is desirable to retain a reduced rate for net capital gains of individuals. In the context of the general reduction of regular individual tax rates under the bill, however, the committee does not believe that it is necessary to retain the same degree of differential between regular rates and capital gains rates as is afforded under present law.

Explanation of Provision

The net capital gain deduction for individuals and other noncorporate taxpayers will be 50 percent for taxable years beginning in 1986 and 42 percent for taxable years beginning in 1986.

In conjunction with the changes made by the bill to the top regular tax rates, the changes in the net capital gain deduction will produce a maximum tax rate of 22 percent (i.e., 50 percent of 44 percent) for net capital gains of individuals in taxable years beginning in 1986 and 22.04 percent (i.e., 58 percent of 38 percent) in taxable years beginning after 1986.

The deduction will be an item of tax preference for purposes of the individual alternative minimum tax; however, under the bill the impact of that tax on net capital gains alone will not result in a greater than 22 percent Federal income tax rate.

The bill coordinates the increased capital gains deduction with the rules applicable to charitable contributions of appreciated property. It provides that the amount of certain charitable contributions of capital gains property is reduced by the percentage of long term capital gain that would have been taxable if the property contributed had been sold by the taxpayer at its fair market value.

Effective Date

The provision applies to net capital gain reportable under the taxpayer's method of accounting in taxable years beginning on or after January 1, 1986, regardless of whether the sale or other transaction giving rise to the gain occurred in a prior year.

Revenue Effect

The revenue effect of this provision is included with the revenue effect for individual rate changes (in title I.A.).

2. Royalty Income From Coal and Domestic Iron Ore (Sec. 242 of the bill and sec. 631(c) of the Code)

Present Law

Subject to certain special limits, royalties received on the disposition of coal and domestic iron ore qualify for capital gains treatment. For capital gain treatment to apply, the coal or iron ore must have been held for six months prior to mining. Capital gain treatment does not apply to income realized by an owner as a co-adventurer, partner, or principal in the mining of the coal or iron ore, or to certain related party transactions.

If capital gain treatment applies under these rules, the royalty owner is not entitled to percentage depletion with respect to the coal or iron ore disposed of.

Reasons for Change

Capital gain treatment for coal and iron ore royalties is an exception from general capital gain principles, which generally do not allow capital gain treatment for royalty income. The committee decided to repeal this provision as part of its general approach of reducing industry-specific tax preferences. To minimize any potential harm to the affected industries, the committee decided to phase out the existing capital gain treatment over a three-year period.

Explanation of Provision

The bill phases out the special capital gain rules for coal and domestic iron ore royalties over a three-year period, beginning January 1, 1986. Under this phaseout, the capital gain exclusion for individuals with respect to coal and domestic iron ore royalties which qualify for present law capital gain treatment under these rules will be reduced to 30 percent for royalties received in 1986, 20 percent in 1987, 10 percent in 1988, and 0 percent (i.e., ordinary income treatment) in 1989 and thereafter.[48] For corporations, the

[48] This is accomplished by including a portion of the royalties as capital gains each year.

tax rate on such royalties will increase to a special capital gain rate of 30 percent in 1986, 31 percent in 1987, and 32 percent in 1988, with the regular corporate tax rates to apply in 1989 and thereafter.[4]

Effective Date

This provision is effective for coal and domestic iron ore royalties properly taken into account on or after January 1, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $9 million in 1986, $32 million in 1987, $47 million in 1988, $76 million in 1989, and $96 million in 1990.

3. Recapture of Certain Amounts Previously Reducing Taxable Income (Secs. 243 and 262 of the bill and secs. 616(c) and 1254 of the Code)

Present Law

Under present law; recapture rules characterize as ordinary income a portion of gain upon the disposition of assets where deductions previously have been allowed with respect to those assets. These recapture rules include the recapture of mining exploration costs (sec. 617(d)), depreciation on personal property (sec. 1245) and intangible drilling costs which would not have been deductible as cost depletion, if capitalized (sec. 1254).

Reasons for Change

The committee believes that if an amount has been allowed as an expense, and, upon the disposition of the asset with respect to which the deduction was allowed, it is determined that the amount allowed exceeded the actual decline in value of the asset, capital gains treatment should generally be denied. This is consistent with the principles now applying, for example, to depreciation of personal property and should generally apply to other types of assets. Exceptions to this rule were retained for specific types of assets, such as real estate and timber. The reasons for these exceptions are discussed in the sections of the bill relating to those subjects.

Explanation of Provision

Under the bill, the present law rules of section 1254 are expanded to apply not only to intangible drilling costs (IDCs) but also to depletion (to the extent the depletion deduction reduced basis). Thus, upon the disposition of an oil, gas, or geothermal property, the amount of gain, if any, treated as ordinary income will include not only excess IDCs, but rather all IDCs and depletion (to the extent depletion had reduced basis) with respect to the property. The bill does not change the present law rules of section 1254 other

[4]The bill repeals the special capital gain tax rate for corporations generally, effective January 1, 1986 (see title III.A, below).

than by including depletion along with intangible drilling costs as the measure of the recapture amount.

The bill also provides similar rules for mining exploration and development costs (sec. 616(c)). Under these rules, all expensed mining exploration and development costs (to the extent not included in income upon reaching the producing stage) as well as depletion, to the extent it reduced basis, will be subject to recapture upon disposition of mining property.

Effective Date

The provision applies to property placed in service by the taxpayer after December 31, 1985, except if acquired pursuant to a written contract binding on September 25, 1985.

Revenue Effect

The revenue effect of this provision is included in the revenue effects shown for the related natural resources provisions of the bill.

F. Oil, Gas, and Geothermal Properties

1. Intangible Drilling and Development Costs (sec. 251 of the bill & sec. 263 of the Code)

Present Law

General rules

Costs incurred by an operator to develop an oil, gas, or geothermal property are of two general types: (1) intangible drilling and development costs, and (2) depreciable costs.[1]

Under present law, intangible drilling and development costs ("IDCs") may either be deducted in the year paid or incurred ("expensed") or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. In general, IDCs include expenditures by the operator incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy), which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property. IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, construct an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs are paid or incurred by the property operator for the labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures necessary to drill the wells and prepare them for production. Finally, IDCs may be paid or accrued to drill, shoot, fracture, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling or development work done by contractors under any form of contract.

Depreciable costs are amounts paid or accrued during the development of a property to acquire tangible property ordinarily considered to have a salvage value. For example, the costs of drilling tools, pipe, casing, tubing, engines, boilers, machines, etc., fall into this category. This class of expenditures also includes amounts paid or accrued for wages, fuel, repairs, etc., in connection with equipment or facilities not incidental or necessary for the drilling of wells, such as structures to store or treat oil or natural gas. These expenditures must be capitalized and depreciated in the same manner as ordinary items of equipment, and they are treated in the same manner for both independent and integrated producers.

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working interest in any tract or parcel of oil or gas-producing land either as a fee owner, or under a lease or any other form of contract granting

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[1] Lease acquisition and certain other costs, including certain geological and geophysical costs, are capitalized and recovered through depletion deductions (see item 2., below).

working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

Generally, if IDCs are capitalized, they can be recovered through depletion or depreciation, as appropriate. However, if IDCs generally are capitalized, a separate election may be made to deduct currently IDCs paid or incurred with respect to a nonproductive well ("dry hole"), in the taxable year in which the dry hole is completed. Thus, a taxpayer has the option of capitalizing IDCs for productive wells while expensing those relating to dry holes.

Twenty-percent reduction for integrated producers

In the case of a corporation which is an "integrated" producer[2] (i.e., which is not an "independent" producer), the allowable deduction with respect to IDCs that the taxpayer has not elected to capitalize is reduced by 20 percent. The disallowed amount must be added to the basis of the property and amortized over a 36-month period, starting with the month in which the costs are paid or accrued. Amounts paid or accrued with respect to non-productive wells (dry hole costs) remain fully deductible when the non-productive well is completed.

Treatment of foreign IDCs

Foreign and domestic IDCs generally are subject to the same rules under present law.

Reasons for Change

Under the bill, the costs associated with building self-constructed assets generally are required to be capitalized and recovered through depreciation, amortization, or depletion deductions after the property is placed in service. In the case of oil and gas property, the committee believed more preferential tax treatment was warranted because of the large amount of risk associated with exploratory drilling and the national security interest in encouraging the discovery of new hydrocarbon deposits.

In approaching IDCs, the committee noted that a majority of presently expensible IDCs are for expenditures which are incurred before the actual decision to proceed to completion of a well is made. The present law treatment of these IDCs is retained by the bill. However, a significant fraction of IDCs are incurred after the decision to complete and produce from a well is made (i.e., when it is determined that the risk of a nonproductive well is sufficiently small). The decision to complete a well generally is evidenced (in the case of onshore wells) by the installation of production casing in the well. Thus, the committee believes that tax incentives to compensate investors for the risks of drilling, and to encourage the discovery of new deposits, are less warranted with respect to ex-

[2] This term is defined in the same manner as it is for purposes of percentage depletion (see item 2., below).

penditures for installing the production string of casing and subsequent development activities.

The bill provides a 26-month amortization period for IDCs which are incurred at or after the production casing point. This is a shorter recovery period than that provided for any depreciation class, and considerably shorter than the asset depreciation range ("ADR") midpoint of oil and gas drilling equipment (i.e., 14 years generally, 6 years for contract drillers, and 7.5 years for offshore wells). The bill also continues to allow any previously unrecovered IDCs to be written off in the year that a dry hole is completed.

The committee believes that the tax incentive provided for IDCs is appropriate only with respect to domestic exploration. Accordingly, the bill requires that IDCs incurred outside the United States be recovered using 10-year amortization or (at the taxpayer's election) as part of the cost depletion basis.

Explanation of Provision

a. Tax treatment of domestic IDCs

Costs incurred prior to production casing point

Under the bill, present law treatment is retained for all domestic IDCs with respect to oil, gas, and geothermal properties that are incurred prior to commencement of the installation of the production string of casing in the well. These include all costs (including costs associated with surface casing) which are classified as IDCs under present law and which are incurred before the installation of the production string of casing. These costs may be expensed or capitalized, as under present law, at the election of the operator. In the case of integrated producers, 80 percent of these costs may continue to be expensed and (if expensing is elected) the remaining 20 percent will be amortized over a 36-month period, as under present law. A separate election continues to be allowed with respect to dry hole costs.

Costs incurred at or subsequent to production casing point

The bill modifies the tax treatment of domestic IDCs that are associated with the installation of the production string of casing or that are incurred subsequent to, or simultaneously with, the commencement of such installation. In lieu of expensing, these costs are to be amortized over a 26-month period, beginning in the month in which the costs are paid or incurred.[3] Costs subject to this rule include all costs that are classified as IDCs under present law and that are incurred during the indicated period. For example, these costs may include (but are not limited to) costs associated with the running of the production string of casing, cementing, running the tubing string, placing packers, perforation of the casing, and other similar costs incurred at or subsequent to the production casing point. The committee intends that equivalent rules will apply in the case of offshore wells.

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[3] The bill does not affect the option to capitalize any IDCs as contained in present law. See also Code section 59, relating to special elections to capitalize certain expenditures, including IDC's, in order to avoid characterization of these expenditures as minimum tax preference items.

The 20-percent reduction for integrated producers does not apply to IDCs for which 26-month amortization is applicable under the bill. Thus, unless capitalization has been elected, 100 percent of these IDCs are to be amortized over 26 months by all taxpayers.

The bill does not affect the ability to deduct unrecovered IDCs with respect to a dry hole (including those IDCs otherwise subject to 26-month amortization) in the year the dry hole is completed. If expensing of these costs is elected, the unamortized balance of IDCs incurred at or subsequent to the production casing point is to be deducted in the year in which the dry hole is completed. For example, if an amortizable cost is incurred in September of year 1, and the dry hole is completed in year 2, then (assuming a calendar year taxpayer) 4/26 of the relevant cost would be recovered in year 1 and the balance (22/26) would be recovered in year 2.

The bill provides that the 26-month amortization rule does not apply below the lowest production level. The committee understands that, in certain cases, it may be impossible to determine at the time that casing is installed whether production will occur below a certain level. In these cases, it may also be impossible to determine whether a particular casing eventually will serve as production (as opposed to intermediate) casing. This may occur, for example, when a well is plugged-back and completed at a higher producing level after a deeper deposit, which may have been the original drilling objective, proves nonproductive. The committee intends that, in such cases, IDCs incurred subsequent to the commencement of installation of casing which eventually serves as production casing, are to be amortized over the 26-month period provided in the bill. IDCs associated with the unsuccessful deeper drilling may (at the taxpayer's election) be written off as an ordinary business loss in the year the well is plugged-back. The committee recognizes that these rules may require the filing of amended returns in cases in which the determinations above cannot be made prior to the close of the taxable year. *See*, Rev. Rul. 77-136, 1977-1 C.B. 167 (regarding treatment of plugged-back wells for percentage depletion purposes).

These provisions apply with respect to oil, gas, and geothermal properties.

b. Foreign IDCs

Under the bill, IDCs incurred outside the United States are recovered (1) over a 10-year straight-line amortization schedule beginning in the year the costs are paid or incurred, or (2) at the taxpayer's election, by adding these costs to the basis for cost depletion. For this purpose, the United States includes the 50 states, the District of Columbia, and those continental shelf areas which are adjacent to United States territorial waters and over which the United States has exclusive rights with respect to the exploration and exploitation of natural resources (sec. 638(1)). The 20-percent reduction for integrated producers does not apply to these costs.

c. Coordination with recapture provision

IDCs deductible under the 26-month amortization rule or the rules regarding foreign IDCs are taken into account for purposes of

determining the amount of recapture on the disposition of certain oil, gas, or geothermal properties (sec. 1254).[4]

Effective Date

These provisions are effective for costs paid or incurred after December 31, 1985.

Revenue Effect

This program is estimated to increase fiscal year budget receipts by $431 million in 1986, $483 million in 1987, $151 million in 1988, $71 million in 1989, and $85 million in 1990.

2. Depletion for Oil, Gas, and Geothermal Properties (secs. 252-54 of the bill and sec. 613 and 613A of the Code)

Present Law

General rules

Certain costs incurred prior to drilling an oil- or gas-producing property are recovered through depletion deductions. These include costs of acquiring a lease or other interest in the property, and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property (including royalty interests).

Two methods of depletion currently are allowable under the Internal Revenue Code: the cost depletion method, and the percentage depletion method. Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property[5] which is equal to the ratio of units produced and sold from that property during the taxable year to the number of units at the beginning of the taxable year. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the net income from that property in that year (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income. Because percentage depletion is computed without regard to the taxpayer's basis in a property, it may result in eventual recovery of an amount greater than the taxpayer's basis in the property.

A taxpayer is required to determine its depletion deduction for each oil and gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question.

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[4] See section 243 of the bill regarding modifications to this provision.

[5] In general, the term "property", for depletion purposes, means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. In the case of oil and gas wells and geothermal deposits, all of a taxpayer's operating interests in each separate tract or parcel of land generally are treated as one property, subject to an election to separate certain interests in the same tract or parcel.

Limitation to independent producers, etc.

The Tax Reduction Act of 1975 repealed percentage depletion with respect to much oil and gas production. (This provision does not apply to geothermal wells.) Under that Act, independent producers and royalty owners[6] (as contrasted to integrated oil companies) are allowed to take percentage depletion for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (including wells located in U.S. possessions).[7] For producers of both oil and natural gas, this limitation applies on a combined basis.

For purposes of percentage depletion, an independent producer is any producer who is not a "retailer" or "refiner." A retailer is any person who directly, or through a related person, sells oil or natural gas or any product derived therefrom (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person obligated to market or distribute such oil or natural gas (or product derived therefrom) under the name of the taxpayer or related person. In determining whether or not a person is a retailer, bulk sales to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are excluded. Further, a person is not a retailer within the meaning of this provision if the combined gross receipts of that person and all related persons from the retail sale of oil, natural gas, or any product derived therefrom, do not exceed $5 million for the taxable year.

A refiner is any person who directly or through a related person engages in the refining of crude oil, but only if such taxpayer or related person has a refinery run in excess of 50,000 barrels on any day during the taxable year.

To prevent proliferation of the independent producer exception, all production owned by businesses under common control and members of the same family must be aggregated. Each group is then treated as one producer for application of the 1,000-barrel amount. Further, if an interest in a proven oil or gas property is transferred after 1974 (subject to certain exceptions), the production from such interest does not qualify for percentage depletion. The exceptions to this rule include transfers at death, certain transfers to controlled corporations, and transfers between controlled corporations or other business entities.

Depletion of geothermal deposits

Percentage depletion also is allowed at a 15-percent rate for geothermal deposits located in the United States or U.S. possessions. This treatment is applied without regard to the 1,000 barrel per day limitation or the restriction to independent producers which apply in the case of oil and gas; additionally, there is no limitation to 65 percent of overall taxable income. (A limitation to 50 percent of net income from the property remains applicable.)

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[6] See discussion of lease bonuses and advance royalty payments, below.

[7] As originally enacted, the depletable oil quantity was 2,000 barrels of average daily production. As provided in the 1975 Act, this was gradually phased down to 1,000 barrels for 1980 and thereafter. The 1975 Act also phased down the percentage depletion rate from 22 percent in 1975 to 15 percent in 1984 and thereafter.

Percentage depletion for lease bonuses and advance royalties

Following the 1975 depletion amendments, disagreement arose whether lease bonuses, advance royalties, and other amounts paid in advance of actual production from an oil or gas property continued to be entitled to percentage depletion.

In January, 1984, the Supreme Court held that a bonus or advance royalty paid to a lessor in a year in which no oil or gas is produced is subject to percentage depletion, notwithstanding the 1,000 barrel per day limitation contained in the 1975 legislation (*Commissioner v. Engle*, 464 U.S. 206 (1984)). The Court left open the possibility that the Treasury Department could promulgate regulations giving effect to the 1,000 barrel per day limitation in such cases.

In June, 1984, the IRS announced the manner for determining percentage depletion by recipients of bonuses and advance royalties. According to this announcement, a bonus or advance royalty is taken into account for depletion purposes in the same year that the payment is includible in income (i.e., generally the year received). Bonus or advance royalty payments are converted to barrel-equivalents based on the average price of oil or gas produced from the property during the taxable year (if no oil or gas is produced or sold from the property, based on representative market or field prices), with percentage depletion being allowed only for the equivalent of 1,000 barrels per day of oil production. No percentage depletion allowance is provided for in any year other than the year in which the bonus or advance royalty is includible in income (I.R. Ann. 84-59, IRB 1984-23, June 4, 1984).

Reasons for Change

While nominally a form of cost recovery, percentage depletion has functioned, at least in part, as a tax incentive for domestic oil and gas production. Unlike cost depletion, percentage depletion is unrelated to the actual costs expended to acquire and develop a property, and may in certain cases exceed those costs. Percentage depletion reduces the effective rate of tax on oil and gas property. Additionally, percentage depletion (as contrasted, for example, with expensing treatment of IDCs) benefits only producing properties; thus, it encourages depletion of existing reserves, which may be counter to the nation's interest in maintaining a reserve for future production. Percentage depletion also is an inefficient subsidy, insofar as it disproportionately benefits those wells which produce most rapidly and therefore may require the least subsidy.

The bill provides substantial rate reductions applicable to all income. Thus, percentage depletion generally is phased out. However, the committee decided to retain it for so-called "stripper" wells of independent producers and royalty owners. The committee was concerned that the elimination of percentage depletion would cause economic hardships to many small producers and royalty owners.

In retaining percentage depletion for royalty owners, the committee wished to provide an incentive only with respect to actual production from stripper wells. Accordingly, the committee decided to specify that no percentage depletion is available for lease bonuses, advance royalties, or other payments which are not directly

related to the actual production from a property. This provision reverses a 1984 Supreme Court decision which requires that some form of percentage depletion be allowed for such payments.

Explanation of Provision

Three-year phaseout for non-stripper properties

The bill phases out percentage depletion for oil, gas and geothermal properties, other than stripper wells, over a 3-year period. This is accomplished by reducing the applicable percentage depletion rate by 5 percentage points in each of the next 3 calendar years (i.e., the percentage depletion rate will be 10 percent for production in calendar year 1986, 5 percent in 1987, and 0 percent in 1988 and thereafter). As under present law, taxpayers will be required to use the higher of cost or percentage depletion for any year in which both are available. Beginning in 1988, taxpayers will be required to use cost depletion.

Exception for domestic stripper wells

Percentage depletion is retained under the bill for domestic stripper well properties of independent producers and royalty owners (subject to the limitations in section 613A). The term "stripper well property" is defined (in the case of oil-producing properties) as it is for purposes of the crude oil windfall profit tax (secs. 4994(g)(1)(B) and 4991(d)(1)(A)) (i.e., generally those properties whose average daily production has been 10 barrels or less of crude oil per day during a specified period). Stripper well gas generally is defined as it is under section 108(b) of the Natural Gas Policy Act of 1978. The committee specifically intends that, in the case of oil-producing properties, the "once a stripper, always a stripper" rule of present law, under which later increases in production do not disqualify a property from stripper well status, will be retained for percentage depletion purposes.

The bill specifies that, for calendar year 1986 and 1987, the 1,000 barrel per day limitation for independent producers and royalty owners (or its natural gas equivalent) is to be reduced by any stripper well oil or gas which is attributable to the taxpayer. Thus, percentage depletion will be allowed at the applicable phase-out rate (10 percent in 1986 and 5 percent in 1987) for 1,000 barrels of average daily production reduced by the amount of stripper well production which qualifies for a full 15 percent rate.

Denial of depletion for bonuses and advance royalties

The bill provides that percentage depletion is not allowed for lease bonuses, advance royalties, or any other amount payable without regard to actual production from the property. This rule applies both to stripper well properties and to other independent producers and royalty owners during the 3-year phaseout period. The rule applies to oil, gas, and geothermal properties.

Effective Dates

The phaseout of percentage depletion for non-stripper wells is effective for production after December 31, 1985. The phaseout of

percentage depletion for geothermal properties is effective in taxable years beginning after December 31, 1985.

The denial of percentage depletion for bonuses and advance royalties is effective on January 1, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $183 million in 1986, $480 million in 1987, $672 million in 1988, $790 million in 1989, and $827 million in 1990.

3. Exemption from Windfall Profit Tax for Certain Crude Oil Exchanged for Residual Fuel Oil (sec. 255 of the bill and sec. 4991 of the Code)

Present Law

Present law imposes an excise tax (the crude oil windfall profit tax) on domestically produced crude oil when the oil is removed from the premises on which it was produced (secs. 4986 et seq.).

The Joint Statement of Managers for the Crude Oil Windfall Profit Tax Act of 1980 indicated that "powerhouse" fuel (i.e., fuel used to power production equipment or a production process) which is produced on one section of a single undivided piece of land is not taxable if it is used on another section of the same piece of land as powerhouse fuel and never leaves the piece of land on which it is produced.[8] Present law thus does not impose the windfall profit tax on such crude oil used in enhanced recovery processes on the property from which it was produced.

Present law does impose the windfall profit tax in a situation in which crude oil is exchanged at a refinery for residual fuel which is used to power a production process on the property. *See*, Rev. Rul. 82-160, 1982-2 C.B. 349.

Reasons for Change

The committee understands that, prior to enactment of the crude oil windfall profit tax, heavy oil producers frequently exchanged crude oil produced on a property for other, residual fuel. This residual fuel oil then was used to produce steam to power enhanced recovery processes on the producing property.

Because the windfall profit tax applies to any crude oil which is removed from the property, the committee understands that many operators have ceased to exchange crude oil for residual fuel, instead burning crude oil produced on the same property in order to power enhanced recovery processes. (But for the tax, it is generally more cost efficient to burn residual rather than crude oil in such processes.)

The committee amendment corrects this by exempting certain exchanges of crude oil for residual fuel oil from the windfall profit tax. To prevent abuse, the provision is subject to various limitations. First, the provision applies only to residual fuel which is to be used in enhanced recovery processes, not including processes

[8] The windfall profit tax treatment of such oil was to have no implication for income tax purposes. H.R. Rpt. No. 96-817, 96th Cong., 2d Sess. 105-106.

that have the sole purpose of lifting fluids to the well bore. Second, the provision is limited to production attributable to operating mineral interests in the producing property. The provision is further limited to cases in which the acquired residual oil is used in enhanced recovery processes during the same quarter or the quarter following that in which the crude oil is removed from the property. These restrictions are intended to limit the effect of the provision to exchanges which have the purpose described above, i.e., of burning residual fuel oil rather than lease crude for use in enhanced recovery processes, as generally would have been the case in the absence of the windfall profit tax. Restrictions are also included to ensure that the proper amount of oil will be subject to the tax; this is accomplished by requiring untaxed lease crude to be exchanged barrel-for-barrel with either previously taxed residual oil or residual oil produced from lease crude.

The committee believes that, if exchanged crude oil is exempted from the windfall profit tax, it should be treated for all tax purposes as if it were not produced on the property. Accordingly, under the bill, crude oil which is subject to the exception is excluded from the computation of depletion deductions.

Explanation of Provision

The bill provides a statutory exemption from the Crude Oil Windfall Profit Tax for certain production which is exchanged for residual fuel used in enhanced recovery processes on the producer's property. This exempt oil is so much of the producer's otherwise taxable crude oil as (1) is removed from the property during the calendar quarter, (2) is attributable to an operating minerals interest of the producer, and (3) is exchanged solely for an equal number of barrels of residual fuel oil used by the producer during the same or the succeeding quarter in enhanced recovery processes with respect to the property. It is intended that an exchange for this purpose includes a situation in which the owner of a property delivers crude oil to a refinery which removes the light hydrocarbons from the oil and returns the residual to the producer for use in enhanced recovery processes.

A person's share of residual fuel oil used on the property is to be the same as that person's share of production from the property for the quarter in question. (Only production attributable to operating mineral interests is taken into account for this purpose.) The bill authorizes the Treasury Department to prescribe rules for allocating a person's exempt production among and within the various tiers of taxable crude oil provided under the windfall profit tax.

The exemption in the bill is limited to cases in which residual fuel oil is used in enhanced recovery processes. For example, the exemption will apply if residual fuel is used to create steam for use in an enhanced recovery process with respect to heavy crude oil. The exemption does not apply if residual fuel is used to power production equipment or a production process which are not part of an enhanced recovery process. An enhanced recovery process is defined as any process for increasing the ultimate total recovery of oil from a reservoir by modifying any property of any fluid in the reservoir or reservoir rock, or any process for displacing or control-

ling the flow rate or pattern in the reservoir. Enhanced recovery processes do not include any process the sole purpose of which is to aid in lifting fluids to the well bore.

Residual fuel oil is defined to include No. 4, No. 5, or No. 6 fuel oil, Bunker C oil, Navy Special Fuel Oil, or any other fuel which has a 50-percent boiling point in excess of 1700 degrees Fahrenheit in the ASTM D-86 standard distillation test.

The exemption does not apply to any oil attributable to nonoperating mineral interests such as royalty interests.

The bill specifies that no depletion (including cost or percentage depletion) is available with respect to oil exempt from the windfall profit tax as a result of the exception.

Effective Date

This provision applies to residual fuel used, and crude oil removed, after the date of enactment.

Revenue Effect

This provision is estimated to have a negligible effect on budget receipts.

G. Hard Minerals

1. Reduction of Percentage Depletion for Certain Minerals (Sec. 261 of the bill and sec. 613 of the Code)

Present Law

Taxpayers are permitted to recover acquisition and certain related costs of mines and mineral deposits under one of two methods: (1) cost depletion, or (2) percentage depletion. Percentage depletion must be elected in any taxable year unless cost depletion would result in a larger deduction.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units sold from that property during the taxable year, to the number of units remaining as of the beginning of that year. As a result of the method of computation, the amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property, ranging from 5 to 22 percent. Generally, percentage depletion is allowed for all minerals except soil, dirt, turf, water, mosses, or minerals from sea water.

The amount deducted for any mineral may not exceed 50 percent of the net income from the property in any taxable year (the "net income limitation").

Unlike cost depletion (or the general rules for recovering costs of depreciable and amortizable property), percentage depletion is computed without regard to the taxpayer's basis in the property. One consequence is that percentage depletion deductions can exceed the amount expended by the taxpayer to acquire the property.

In the case of a corporation, the amount of percentage depletion for coal (including lignite) and iron ore is reduced by 15 percent to the extent in excess of the adjusted basis of the property.[9]

Reasons for Change

The percentage depletion provisions under present law generally are viewed as an incentive for mineral production rather than as a normative rule for recovering the taxpayer's investment in the property. It is the committee's view that some portion of the present law incentive should be retained; however, the wide variation in statutory rates (from 5 to 22 percent) no longer appears to serve any public policy purpose. The tax preference in present law creates undesirable distortions in mineral production by favoring

[9] An adjustment is made in the case of coal and iron ore to prevent the combination of both the 15 percent reduction and the minimum tax preference for percentage depletion from reducing the tax benefit from percentage depletion below the level under pre-1983 law.

high rate minerals (such as sulphur) over low rate minerals (such as clay).

The bill phases down most depletion rates to 5 percent, which creates a more uniform tax incentive for these minerals. In several instances, the committee departed from the general 5-percent rate. First, with respect to minerals that are accorded the lowest depletion rate (5 percent) under present law (e.g., sand and gravel) the committee believes that there is little justification for retaining any depletion incentive. These minerals generally are in abundant supply and have little strategic value. Consequently, the committee decided to phase out completely percentage depletion with respect to these minerals.

Second, with respect to minerals that are used as or in fertilizer or animal feed, the committee decided to retain present law depletion rates. The principal reason for the more favorable treatment of agriculture minerals is the committee's desire to avoid a further squeeze on farm income.

Third, with respect to dimension stone (primarily granite, limestone, sandstone, and marble used for ornamental purposes) the committee also decided to retain present law rates. The committee was concerned about the depressed state of the U.S. dimension stone industry, which is in part due to intense foreign competition.

While retaining some amount of percentage depletion for most minerals, the committee was concerned that taxpayers not be able to escape tax on profits from mineral production. For this reason, the present law income limitation was phased down from 50 to 25 percent, except for agricultural minerals and dimension stone. As a result, under the bill, the percentage depletion deduction generally cannot be used to shield from tax more than 25 percent of otherwise taxable income from a property (computed without allowance for depletion). For a large corporation, the rate of tax on mineral income generally would be at least 27 percent (75 percent of the 36-percent corporate rate).

Explanation of Provison

Under the bill, present law depletion rates for mineral deposits generally are phased down ratably to 5 percent in 1988. For example, the percentage depletion rate for minerals presently entitled to a 14 percent depletion rate will be phased down to 11 percent for production in 1986, 8 percent for production in 1987, and 5 percent for production after 1987.

Minerals that are accorded a 5-percent depletion rate under present law are phased down ratably to a zero depletion rate in 1988. (From 5 percent under present law, to 3-1/3 percent for production in 1986, to 1-2/3 percent for production in 1987, and to zero for production after 1987.)

Minerals that are used in the production of fertilizer and animal feed ("agricultural minerals") retain their present law percentage depletion rates. Agricultural minerals include minerals used by the mine owner for the production of fertilizer or animal feed, sold for use (or resale for use) in the production of fertilizer or animal feed, or sold for direct application as fertilizer or animal feed.

Minerals that are used or sold for use as dimension stone also retain their present law percentage depletion rates. Dimension stone generally is defined as stone that is not crushed, and is used for ornamental purposes.

Under the bill, the present law net income limitation is phased down ratably from 50 to 25 percent for tax years beginning in 1988. Thus, the limitation would be 41-2/3 percent for tax years beginning in 1986, 33-1/3 percent for tax years beginning in 1987, and 25 percent for tax years beginning after 1987.

The 50-percent net income limitation in present law is retained for minerals used in fertilizer and animal feed and dimension stone. In situations where only some minerals from a property qualify for the present law 50-percent net income limitation (i.e., minerals used in the production of fertilizer or animal feed and dimension stone), the bill provides that the net income limitation shall be determined by taking into account nonqualified production first. For example, if a mine in 1990 produces sulphur used for both agricultural and industrial purposes, the percentage depletion on the latter sulphur may be deducted up to 25 percent of net income from the property, and the percentage depletion on the former sulphur may be used to offset remaining net income up to 50 percent of net income (determined before depletion deductions) from the property.

The present law 15-percent reduction in corporate coal and iron ore depletion deductions in excess of adjusted basis is retained.

Effective Date

The changes in depletion rates generally are effective for production after December 31, 1985. The change in the income limitation is effective for tax years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $70 million in 1986, $183 million in 1987, $313 million in 1988, $397 million in 1989, and $434 million in 1990.

2. Treatment of Mining Exploration And Development Costs (Sec. 262 of the bill and secs. 616 and 617 of the Code)

Present Law

General rules

Under present law, taxpayers may elect to expense (i.e., to deduct currently) exploration costs associated with hard mineral deposits (sec. 617). Taxpayers also may expense development costs associated with the preparation of a mine for production (sec. 616).

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other depletable mineral, which are paid or incurred by the taxpayer prior to the development of the mine or deposit. When, the mine reaches the producing stage, adjusted exploration expenditures (but not development costs) either: (1) are included in income (i.e., recaptured) and recovered through cost depletion; or

(2) at the election of the taxpayer, reduce depletion deductions with respect to the property. Adjusted exploration expenditures with respect to a property are expensed exploration costs attributable to the property, reduced by the excess of percentage over cost depletion. Exploration costs also are subject to recapture if the property is disposed of by a taxpayer after expensing these amounts (secs. 1245 and 1250). Foreign exploration costs may not be expensed to the extent that the taxpayer's total costs of foreign and domestic exploration exceed $400,000 for the taxable year.

Development costs include expenses incurred for the development of a property after the existence of ores in commercially marketable quantities has been determined. These costs generally include costs for construction of shafts and tunnels and, in some cases, costs for drilling and testing to obtain additional information for mining operations.

Twenty-percent reduction for corporations

For corporations, 20 percent of exploration and development costs that the taxpayer has elected to expense are required to be capitalized and recovered using the schedule for 5-year accelerated cost recovery system ("ACRS") property (sec. 291). For deposits located in the United States, such expenses also qualify for the investment tax credit.

Reasons for Change

Under present law, pre-production costs of a mine are treated differently for income tax purposes depending on whether such costs are characterized as exploratory or developmental in nature. There are a number of arguments for expensing mining exploration and development costs, including: the significant risks involved in finding and developing a mineral deposit (which may be comparable to the risks involved in research and development expenditures); and the importance of providing a tax incentive for mineral development given national security concerns and the current depressed state of the mining industry. However, others argue that these costs are analogous to production costs for self-constructed property and, accordingly, should be capitalized.

The committee decided to take an intermediate position between expensing of mine exploration and development costs, on the one hand, and capitalization, on the other hand. Under the bill, these costs are expensed (with a 20-percent cutback for corporations), but are subject to recapture if the mine reaches the producing stage, and then recovered as expenditures for depreciable property in class 1. This treatment conforms the tax treatment of development and exploration costs, and provides tax benefits that fall between expensing and capitalization treatment. The bill also simplifies present law, since there is no longer any need to distinguish for tax purposes between exploration and development costs.

Explanation of Provision

Domestic exploration and development costs

Under the bill, the treatment of pre-productive mining development costs generally is conformed to the treatment of exploration costs under present law. Thus, the option initially to expense these costs is retained. At the time that a mine reaches the producing stage, all exploration and development costs with respect to a mine that were expensed in any taxable year (after the effective date), (1) will be recaptured and recovered in the same manner as depreciable property in class 1 (i.e., 3-year double-declining balance with a half-year convention), or (2) at the election of the taxpayer, will reduce the amount of otherwise allowable depletion deductions. Development costs incurred after the mine reaches the producing stage are capitalized and recovered in the same manner as depreciable property in class 1.

The bill retains the cutback in present law which requires that corporations capitalize 20 percent of mineral exploration and development costs that the taxpayer has elected to expense. However, this amount is to be recovered in the same manner as depreciable property in class 2 (i.e., 5-year double-declining balance with a half-year convention), beginning in the year paid or incurred.

The present law rules regarding recapture on disposition of mining property are expanded to require recapture of previously deducted development as well as exploration costs. The recapture rule also is expanded to cover previous depletion deductions which reduced the basis of the disposed property. This is consistent with a similar change with respect to oil and gas properties (sec. 251 of the bill).

Foreign expenditures

The bill requires capitalization of all exploration and development costs with respect to minerals located outside of the United States. These costs are to be recovered over a 10-year straight-line amortization schedule, or at the election of the taxpayer, as part of the basis for cost depletion.

Effective Date

The provision generally is effective for costs paid or incurred after December 31, 1985.

The amendments to the recapture rules upon disposition of certain mining property apply to dispositions of property in commercial production during 1986 or later years. A transitional exception is provided for property placed into production after December 31, 1985 and acquired pursuant to a written contract entered into before September 26, 1985, and binding at all times thereafter. (Property not subject to these amendments remains subject to the present law recapture rule (sec. 617(d) of present law)).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $14 million in 1986, $40 million in 1987, $63 million in 1988, $66 million in 1989, and $49 million in 1990.

H. Energy and Fuels Tax Provisions

1. Residential Energy Tax Credits (Sec. 271 of the bill and sec. 23 of the Code)

Present Law

Energy conservation credit

Individuals are allowed a 15-percent credit on the first $2,000 of qualifying expenditures, up to a maximum credit of $300, for installations of eligible insulation and other energy conservation items made through 1985 in or on a taxpayer's principal residence that was substantially completed before April 20, 1977. Each conservation item, listed below, must be capable of reducing heat loss or gain, increasing the efficiency of the heating system, or reducing fuel consumption. Unused credits may be carried over to subsequent taxable years but not to any taxable year beginning after 1987.

In addition to insulation, energy conservation items specified in the statute include (1) a furnace replacement burner, (2) a device to modify flue openings, (3) an electrical or mechanical furnace ignition system to replace a gas pilot light, (4) exterior storm or thermal windows or doors, (5) an automatic setback thermostat, (6) exterior caulking or weatherstripping, (7) an energy usage display meter, or (8) any additional item specified in regulations by the Secretary as increasing energy use efficiency of the dwelling.

Renewable energy credit

Individuals are allowed a 40-percent credit on expenditures up to $10,000, for a maximum credit of $4,000, for renewable energy source property. This provision applies to expenditures made through 1985.

Installations of qualified renewable energy source property, which include solar, wind, photovoltaic and geothermal energy sources, must be made in connection with a taxpayer's principal residence. Unused credits for renewable energy source equipment may be carried over to subsequent taxable years but not to any taxable year beginning after 1987.

As defined in the regulations issued by the Treasury Department, renewable energy source property includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit. A geothermal deposit is defined as a geothermal reservoir consisting of natural heat, which is from an underground source and is stored in rocks or in an aqueous liquid or vapor, having a temperature exceeding 50 degrees Celsius, which is 122 degrees Fahrenheit. The regulations also provide that equipment which serves both a geothermal

function and a nongeothermal function does not qualify as geothermal energy property.

Reasons for Change

Both the residential energy conservation tax credit and renewable energy tax credit were enacted in the Energy Tax Act of 1978. Enactment took place during a period when oil and natural gas price controls were in effect, and consequently market incentives alone were not strong enough to encourage homeowners to modify their homes to conserve energy.

The intent of the Energy Tax Act was to encourage residential and business energy users to conserve petroleum and natural gas through more efficient uses and to develop and encourage a broad variety of alternative sources of domestic energy supply. The energy conservation credit was designed to stimulate households to take the steps to prevent heat loss during cold weather and heat gain of air conditioned houses during hot weather. This was reflected in the conservation credit being made available for insulation, caulking, storm doors and windows, programmed thermostats and efficient replacement burners. Solar, wind and geothermal energy sources were to be stimulated through the renewable energy source credit. These alternate energy sources were not expected to become complete replacements for petroleum and natural gas products, but there was optimism that they would substantially reduce the quantities of oil and gas consumed for residential purposes.

After seven years of experience with the residential credit, the committee evaluated the extent to which the objectives of the legislation have been realized. Generally, it found that the energy conservation credit has achieved its purpose. Residential housing eligible for the credit has benefited from the addition of items eligible for the credit which quickly provided greater cost savings than their relatively modest purchase prices. In addition, new housing has been constructed with insulation and other energy conservation items in response to market factors and without eligibility for the credit. Consequently, the committee decided that renewal of the conservation credit would not be needed.

Experience with the renewable energy credit demonstrates that solar energy uses, and primarily solar hot water systems, have been the only generally used renewable credits. Residential geothermal systems are limited geographically to a small number of local areas, and geothermal use technology has not been readily and economically adaptable to residential use. Residential wind systems apparently have not been feasible except possibly in certain local areas that meet very specific environmental requirements. Solar systems, however, have been adaptable to a wide variety of regional conditions and to a variety of modifications in the systems that satisfy personal and local conditions. Each installed solar system, however, involves several thousand dollars of investment in equipment, piping and specialized media used for heat exchange purposes. Therefore, the committee provided a transition rule that allows an extension for three years and a phaseout of the credit rates of the residential solar energy tax credit.

Explanation of Provision

The residential solar energy tax credit is extended for three years, through December 31, 1988, and the tax credit rate during that period will be 30 percent of qualified expenditures in 1986, and 20 percent in 1987 and 1988. The limit on qualified expenditures is $10,000 generally, but the limit is reduced to $5,000 for solar energy hot water systems. Present law provisions and the applicable regulations will continue in effect, except for a change relating to greenhouses and similar enclosures.

The committee modified the credit so that it is applicable during the extension period only to equipment installed and used in a residential solar energy system. A frame or wall which contains transparent glass, plastic or their counterparts and which encloses an area and creates, in effect, a sunroom or a greenhouse will not be treated as solar energy equipment. Glazing material that is attached directly to solar equipment, e.g., the covering of a heat absorber placed on a roof or suspended from a wall, is treated as a constituent component of the heat absorbing equipment unit and eligible for the credit as a component of the heat absorber.

The present law two-year carryforward rule for the solar energy credit also is extended for an additional three years, thus making it possible to carryforward unearned residential solar credits through 1990. The provision in present law which allows carryforward of unused residential geothermal and wind energy credits through 1987 is continued and will terminate as scheduled.

The residential energy tax credits for insulation and other energy conservation property, geothermal property, wind energy property, and photovoltaic property are allowed to expire after December 31, 1985, as scheduled in present law. The two-year carryforward of unused credits is continued through 1987, as in present law.

Effective Date

The extension of the credit for certain solar energy property is effective for expenditures and installations made after December 31, 1985, and before January 1, 1989. The other residential energy property tax credits will expire, as in present law, after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $16 million in 1986, $159 million in 1987, $98 million in 1988, $84 million in 1989, and $8 million in 1990.

2. Business Energy Tax Credits (Sec. 272 of the bill and secs. 46 and 48 of the Code)

Present Law

Business energy investment tax credits were enacted initially in the Energy Tax Act of 1978 and further increased or modified in the Windfall Profit Tax Act of 1980. Several of the credits enacted in 1978 were allowed to expire in 1982 as scheduled, and all of the

remaining business energy credits are scheduled to expire after 1985. The business energy investment tax credits were enacted as additions to the regular investment tax credit and, in almost all cases, provided an additional tax credit for the purchase of the specified pieces of equipment.

Solar or wind energy property

A 15-percent energy tax credit is allowed for placing in service before January 1, 1986, solar or wind energy property, which is defined to include any equipment which uses solar or wind energy to generate electricity, to heat or cool a structure or provide hot water for use within the structure, or to provide solar process heat. Generally, these functions are accomplished by the use of such equipment as collectors which absorb sunlight and create hot liquids or air, storage tanks to store hot liquids, rockbeds to store heat, thermostats to activate pumps, fans to circulate hot air, and heat exchangers. The business solar energy credit does not apply to passive solar applications.

Geothermal and ocean thermal property

Energy credits of 15 percent also are allowed for ocean thermal property only at 2 locations designated by the Secretary and geothermal property. The credit for geothermal property covers equipment used to produce, distribute, or use energy derived from a geothermal deposit, but in the case of electricity generated by geothermal power, only up to (but not including) the electrical transmission stage. The term geothermal deposit has the same meaning for the business energy investment credit as that provided in Treasury regulations for the residential renewable energy credit, which is summarized above.

Ocean thermal property includes equipment which converts ocean thermal energy through a heat exchange system into energy usable for generation of electricity. The credit was made available for equipment that could be placed in service at the locations which would be designated by the Secretary of the Treasury after consultation with the Secretary of Energy.

Small-scale hydroelectric generating property

An 11-percent energy credit has been allowed for equipment placed in service at a qualified hydroelectric site. A qualified site is one at which there is a dam that was completely constructed before October 18, 1979, and not significantly enlarged after that date, or where electricity can be generated without any dam or other impoundment of water. Eligible property includes equipment to generate electricity (but not equipment for electrical transmission) and structures for housing the generating equipment and fish passageways. The full credit is limited to equipment that provides 25 or more megawatts of generating capacity, and the credit phases out as generating capacity is increased from 100 to 125 megawatts. A qualified site and equipment may not have installed generating capacity greater than 125 megawatts. This credit expires after 1985, but it continues to be available through 1988 for property for which an application has been docketed by FERC by December 31, 1985.

Biomass property

A 10-percent business credit is available for biomass property placed in service before January 1, 1985. In general, biomass property is defined as a boiler or burner that uses an alternate substance and as equipment for converting an alternate substance into a qualified fuel. An alternate substance with respect to biomass property means any property other than oil or natural gas, or any product of oil or natural gas, except that an alternate substance does not include any inorganic substance and does not include coal (including lignite) or any product of such coal. Qualified fuel is defined as any synthetic solid fuel, and alcohol for fuel purposes, if the primary source of energy for the facility producing the alcohol is not oil or natural gas (or a product of oil or natural gas).

Qualified intercity buses

A 10-percent credit is allowed only for the acquisition of an intercity passenger bus that produces an increase in the operating seating capacity of the taxpayer's bus fleet for the taxable year over the preceding year. The bus must be placed in service by a taxpayer which is a common carrier regulated by the Interstate Commerce Commission or an appropriate State agency and which is engaged in the trade or business of furnishing intercity passenger transportation or intercity charter service by bus. A qualified bus must have seating capacity of more than 35 passengers (in addition to the driver), and 1 or more baggage compartments, separated from the passenger area, with a capacity of at least 200 cubic feet.

Reasons for Change

Business energy investment tax credits were enacted in the Energy Tax Act of 1978 and the Windfall Profits Tax Act of 1980 in order to stimulate the development and business application of a broad variety of energy sources which were perceived to be alternatives to petroleum, natural gas, and their products. Generally, the alternative energy sources were well known but, because of price and other advantages of fossil fuel using systems, were not experiencing widespread application, and the energy tax credits were intended to increase demand for alternate energy sources, thus stimulating technological advances in production of equipment and in the design and operating efficiency of the renewable energy source.

Experience with the credits indicates that primarily two alternative energy sources, business solar energy property and geothermal property, have demonstrated responsiveness to the credit and warrant additional limited support through a phaseout of the credit, rather than a full extension of the credits. The credits for the other alternative energy sources or uses are not extended or phased out because they have not demonstrated that the stimulation to demand from a tax credit is necessary. The absence of favorable technological developments in other renewable energy areas or the inability to find ways to reduce potentially high capital or operating costs have convinced the committee that the energy tax credits for most of the other renewable energy property are premature and have failed to stimulate a meaningful level of demand.

The committee found, in addition, that some of the expiring business energy credits were used in conjunction with other tax subsidy provisions in the Code to create generous tax shelters. Furthermore, renewable energy systems used to produce electricity have been able to sell the electricity to electric utility systems at avoided cost—i.e., the utility's cost of generating electricity—which means that in addition to generous tax provisions, the projects were guaranteed a high price for sale of their output. The committee decided to allow these credits to expire as scheduled.

Explanation of Provisions

a. Solar energy property

The business energy tax credit for solar energy systems is extended for three years at declining rates: 15 percent in 1986; 12 percent in 1987; and 8 percent in 1988. The credit will terminate after December 31, 1988. Business photovoltaic cell equipment continues to be eligible for the phased down credit as a form of solar energy. No other changes are made in present law with respect to business solar energy systems.

b. Geothermal energy property

The energy tax credit for geothermal energy systems is extended for a 3-year period at a declining rate: 15 percent in 1986, and 10 percent in 1987 and 1988. The credit will terminate after December 31, 1988. No other changes are made in present law with respect to business geothermal energy systems.

c. Expiring credits

The energy tax credits for wind energy property, ocean thermal energy property, intercity buses, biomass property, and small-scale hydroelectric projects are allowed to expire after December 31, 1985, as is scheduled in present law. With respect to the hydroelectric projects for which applications are docketed by FERC before January 1, 1986, the credit will continue to be available with respect to such docketed projects for equipment placed in service before January 1, 1989.

d. Affirmative commitment

Present law affirmative commitment provisions are continued for energy projects that meet the statutory requirements but, as with the general investment credit, only 20 percent of the credits allowable after 1985 may be used in any one taxable year to reduce tax liability.

Effective Date

The extension and phaseout of the solar and geothermal energy property energy tax credits is effective for expenditures made and equipment placed in service after December 31, 1985, and before January 1, 1989.

Revenue Effect

The provisions relating to business energy tax credits are estimated to decrease fiscal year budget receipts by $18 million in 1986, $28 million in 1987, $24 million in 1988, and $6 million in 1989. Receipts will increase by $4 million in 1990.

3. Nonconventional Sources Fuels Production Tax Credit (Sec. 273 of the bill and sec. 29 of the Code)

Present Law

A tax credit is provided for the domestic production and sale of qualified fuels to unrelated persons. The credit applies to such fuels produced and sold from (1) facilities placed in service after December 31, 1979, and before January 1, 1990, or (2) wells drilled after December 31, 1979, and before January 1, 1990, on properties which first begin production after December 31, 1979. Qualifying fuels may be sold at any time after December 31, 1979, and before January 1, 2001.

The credit equals $3 for each 5.8 million Btu's of energy. (One barrel of crude oil contains approximately 5.8 million Btu's.) All Btu measurements must be made without regard to any Btu's attributable to materials or energy sources other than the qualified fuel. Except for gas produced from a tight formation, the $3 amount is indexed for post-1979 increases in the GNP deflator.

The credit phases out as the annual average wellhead price of uncontrolled domestic oil rises from $23.50 to $29.50 a barrel. The phaseout range is adjusted for post-1979 changes in the GNP deflator and has risen to $32.10 and $40.30, respectively, in 1984 prices.

The credit is available for production and sale of the following fuels:

(1) Oil produced from shale and tar sands;

(2) Gas produced from geopressured brine, Devonian shale, coal seams, or a tight formation;

(3) Gas produced from biomass;

(4) Liquid, gaseous or solid synthetic fuel (including alcohol) produced from coal (including ignite), including such fuels when used as feedstocks;

(5) Qualifying processed wood fuels; and

(6) Steam from solid agricultural byproducts (not including timber byproducts).

Reasons for Change

The committee believes that nonconventional fuels production credit, which has been available for more than 5 years and has been supplemented with ACRS and the investment tax credit has been available for a period long enough to demonstrate whether production technologies have been developed sufficiently to allow the new form of energy to meet the tests of the market. The information made available to the committee indicated that new technologies have not been developed and that generally the resources needed for production, e.g., water, are not available abundantly at the production sites and are too expensive to bring to the produc-

tion site. An exception is made for a new technology that uses wood to produce methane gas for use as a fuel. In addition, the committee considers that in the context of tax reform legislation directed towards simplifying the Internal Revenue Code, the goal of eliminating special industrial incentives, placing industrial activity on the same competitive plane, and reducing the level of corporate tax rates will be more decisive in the long run in the development of efficient alternative fuel technologies.

Because investors in existing facilities relied on the production credits when committing their funds, the committee provides a transitional rule under which the credit continues for the sale of fuels from wells or facilities placed in service before 1986.

Explanation of Provision

The tax credit is terminated after December 31, 1985, for domestic production and sales of fuels, described above, produced from nonconventional sources. Under a transition rule, the credit will continue to be available for qualifying fuel which is produced from a well drilled, or a facility placed in service, before January 1, 1986 and which is sold before 1990.

An exception is made for a new technology with which wood is used to produce methane gas for fuel, if the gas-producing facility is installed on the premises of a facility which will use the methane as a fuel. For installations of this technology, the production credit will be available for fuel sold before 2001 from a facility placed in service before January 1, 1989.

Effective Date

The provision which terminates the production credit for fuels from nonconventional sources applies to wells drilled or facilities placed in service after December 31, 1985. The production credit for those sales of fuels from wells drilled or facilities placed in service on or before December 31, 1985, is terminated after December 31, 1989.

The production tax credit for methane gas fuel produced from wood is available through December 31, 2000, for fuel production from a domestic facility placed in service before January 1, 1989.

Revenue Effect

The provisions relating to repeal of the nonconventional energy sources fuels production tax credits increase fiscal year budget receipts by a negligible amount in each fiscal year during the 1986–1990 period.

4. Alcohol Fuels Credit and Related Excise Tax Exemptions (Secs. 274 and 275 of the bill and secs. 40, 4041, 4081, and 6427 of the Code)

Present Law

Alcohol fuels credit

A 60-cents-per-gallon tax credit is allowed for alcohol used in certain mixtures of alcohol and gasoline (i.e., gasohol), diesel fuel, or

any special motor fuel if the mixture is sold by the producer for use as a fuel or is used as a fuel by the producer. The credit also is permitted for alcohol (other than alcohol used in a mixture with other taxable fuels) if the alcohol is used by the taxpayer as a fuel in a trade or business or is sold at retail by the taxpayer and placed in the fuel tank of the purchaser's vehicle.

The amount of any person's allowable alcohol fuels credit is reduced to take into account any benefit received with respect to the alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels.

The credit is scheduled to expire after December 31, 1992.

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

A 6-cents-per-gallon exemption is allowed from the excise taxes on gasoline, diesel fuel, and special motor fuels for fuels consisting of mixtures of any of those fuels with at least 10-percent alcohol. (This is equivalent to 60 cents per gallon of alcohol in a 10-percent mixture.) The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal. This exemption is scheduled to expire after December 31, 1992.

Alcohol fuels

A 9-cents-per-gallon exemption is allowed from the excise tax on special motor fuels for certain neat methanol and ethanol fuels derived from a source other than petroleum or natural gas. A 4-1/2-cents-per-gallon exemption is provided for these fuels when derived from natural gas. Neat alcohol fuels are fuels comprised of at least 85 percent methanol, ethanol, or other alcohol. This exemption is scheduled to expire after December 31, 1992.

Duty on imported alcohol fuels

Alcohol imported into the United States for use as a fuel is subject to an additional tariff of 60 cents per gallon from most sources. However, under the Caribbean Basin Economic Recovery Act (CBERA), such alcohol produced in a beneficiary country and imported directly into the United States from a beneficiary country would be eligible for duty-free treatment. The same is true under General headnote 3(a) of the Tariff Schedules of the United States (TSUS) for alcohol produced in U.S. insular possessions.

The CEBRA established stringent rules of origin criteria to determine eligibility for duty-free treatment under the Caribbean Basin Initiative (CBI) program in order to discourage the establishment of simple pass-through operations in CBI countries. The U.S. Customs Service has ruled that the distillition of non-CBI beverage grade alcohol via the azeotropic distillation process (which in effect removes the final 5 percent of water in the alcohol bringing it from 190 proof to 199.5 proof) satisfies the substantial transformation criteria required by the CBERA for the alcohol to be considered a product of the CBI country. Therefore the ethyl alcohol which is merely dehydrated/distilled in the CBI country is entitled to duty-free treatment upon import into the United States. Similar rulings

have been issued with regard to alcohol from U.S. insular possessions.

Reasons for Change

Alcohol fuels receive two forms of subsidy which are available either as a nonrefundable income tax credit for producers or blenders or as an excise tax exemption available for sales at the retail level of a gasoline alcohol mixture with at least 10 percent alcohol. Since their enactment, the excise tax exemptions have been used considerably more than the income tax credit because blenders or producers who may not have adequate tax liability to use all of the credits prefer to take the excise tax exemption. In addition, the excise tax exemption makes a more positive contribution to the cash flow of a cash-tight business.

The committee is concerned that the simple distillation process for dehydrating ethyl alcohol does not represent the type of economic activity that will increase employment and productivity in the Caribbean area in the way that was intended in the CBI program.

Explanation of Provision

a. Alcohol fuels credit

The 60-cents-per-gallon nonrefundable income tax credit allowed for alcohol mixed with gasoline, diesel fuel or any special motor fuel is repealed effective after December 31, 1985.

b. Excise tax exemptions for alcohol fuels and mixtures

Gasoline and motor fuels excise tax exemption for mixtures with alcohol and for alcohol fuels are continued in effect as in present law, with one exception. The excise tax exemption for neat ethanol and methanol fuels is reduced from 9 cents per gallon to 6 cents per gallon. As in present law, these exemptions will continue in effect until the scheduled expiration after December 31, 1992.

c. Alcohol import duty

The committee agreed on the need to establish a rule with respect to CBI imports of alcohol which would permit orderly growth in such imports while at the same time phasing out use of the program of merely removing the water from alcohol transferred from other countries. The committee recognized that the U.S. Customs Service made a factual determination that the azeotropic distillation process is sufficient to meet the existing substantial transformation requirements of the CBI and that certain parties have relied in good faith on that ruling. However, the committee finds that this process should be reexamined because it does not represent the real economic investment in the Caribbean region that was envisioned by the committee in establishing the CBI program. The committee has been provided with information which indicates a simple dehydration facility requires only 5-10 percent of the capital investment and far fewer employees to operate than is the case with an "A to Z" ethanol plant which converts the raw agricultural product into fuel grade alcohol. Therefore allowing the azeotrop-

ic distillation process to qualify the alcohol for duty-free entry may actually be retarding economic development in the region by discouraging others from establishing full fermentation operations in the Caribbean. It should also be noted that merely closing the loophole in the CBERA is insufficient if the corresponding loophole is not addressed allowing for the same tariff treatment of azeotropically distilled alcohol from the insular possessions. Therefore, the committee directed the Trade Subcommittee to develop a rule, after receiving the views of interested parties through a public hearing, which would not only encourage imports of fuel alcohols from CBI countries and U.S insular possessions but also encourage meaningful economic investment in these regions by discouraging "pass-through" operations. Such a change should provide transition rules for existing operations which have relied on the Customs Service ruling. The subcommittee was directed to move expeditiously on this matter.

Effective Date

The repeal of the 60-cents-per-gallon credit for blenders and producers is effective after December 31, 1985.

The provision reducing the excise tax exemption for neat ethanol and methanol fuels from 9 cents per gallon to 6 cents per gallon is effective on and after January 1, 1986.

Revenue Effect

The excise tax provisions are estimated to decrease fiscal year budget receipts by $2 million in 1986, $3 million in 1987, $3 million in 1988, and $1 million in 1989.

5. Three-year Extension of Refund of Taxes on Fuels Used in Qualified Taxicabs (Sec. 275 of the bill and sec. 6427 of the Code)

Present Law

Present law imposes excise taxes on the sale of gasoline, diesel fuel, and special motor fuels used in highway motor vehicles. The tax rate is 9 cents per gallon for gasoline and special motor fuels and 15 cents per gallon for diesel fuel. These fuel taxes expire after September 30, 1988. Revenues from these taxes are deposited in the Highway Trust Fund.

A partial 4-cents-per-gallon exemption from the motor fuels taxes was provided for fuel used in certain taxicabs. The exempt portion of the tax was refunded (without interest) to the ultimate purchaser of the fuel. To qualify for this refund, the taxicab had to be operated by a licensed person who was not prohibited by company policy from furnishing shared transportation and generally must not have been of a type with below-average fuel economy. This partial exemption expired on October 1, 1985.

Reasons for Change

The committee believes that the partial fuels tax exemption for qualified fuel-efficient taxicabs promotes energy savings through

shared transportation and warrants a further extension for three years.

Explanation of Provision

The bill reinstates for three years the 4-cents-per-gallon exemption from the gasoline and motor fuels excise tax for those fuels used in qualified taxicabs as of October 1, 1985. Thus, the exemption will expire on October 1, 1988.

Individuals who will be eligible for refunds from October 1, 1985, will be able to follow the same refund procedure that was in effect before October 1, 1985.

Effective Date

The extension of the partial fuels tax exemption for qualified taxicabs is effective as of October 1, 1985.

Revenue Effect

The provision will reduce fiscal year budget receipts by less than $10 million annually.

I. Extensions of Certain Other Tax Credits

1. Extension and Modification of the Targeted Jobs Tax Credit (sec. 282 of the bill and sec. 51 of the Code)

Present Law

Background

The targeted jobs tax credit (Code sec. 51) was enacted in the Revenue Act of 1978 to replace the expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years, and the Deficit Reduction Act of 1984 (the 1984 Act) for one year. Under present law, the credit will not apply with respect to individuals who begin work for the employer after December 31, 1985. For individuals beginning work before 1986, the credit is available for wages paid during the following 24 months of employment (see below).

ERTA, TEFRA, and the 1984 Act altered the targeted group definitions and made several technical and administrative changes in the credit provisions. In addition, TEFRA authorized the appropriation of such sums as may be necessary for the expenses of administering the system for certifying targeted group membership and for the expenses of providing publicity to employers regarding the targeted jobs credit. The 1984 Act extended the authorization for appropriations for administrative and publicity expenses to fiscal year 1985.

Targeted jobs credit rules

The targeted jobs tax credit is available on an elective basis for hiring individuals from one or more of nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths (ages 18-24); (3) economically disadvantaged Vietnam-era veterans; (4) SSI recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students (ages 16-19); (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged summer youth employees (ages 16–17).

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages plus 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to

$3,000 of wages, for a maximum credit of $2,500. The employer's deduction for wages must be reduced by the amount of the credit.

The credit may not exceed 90 percent of the employer's tax liability after being reduced by certain other non-refundable credits. Excess credits may be carried back three years and carried forward 15 years.

Reasons for Change

While the evidence regarding the targeted jobs credit's relative efficiency as a tax incentive for hiring disadvantaged individuals remains incomplete, the committee believes that experience with the credit since its enactment in 1978 has been sufficiently promising to warrant a further two-year extension of the credit. The committee believes that such an extension will provide the Congress and the Treasury Department an opportunity to gather more information on the operation of the credit program so that its effectiveness as a hiring incentive can be more fully assessed.

Although the committee has limited the credit in certain respects, the resulting reduction in tax benefits to some employers will be wholly or partially offset in many cases by the tax savings arising from the bill's general reduction in tax rates.

Explanation of Provision

The bill extends the targeted jobs credit for two more years. Under the bill, the credit is available for wages paid to individuals who begin work for an employer on or before December 31, 1987.

The bill also limits the credit in three respects. First, the 25-percent credit for qualified wages paid in the second year of a targeted individual's employment is eliminated. Second, the 50-percent credit for qualified first-year wages generally is reduced to a 40-percent credit. Thus, the bill, generally reduces the maximum credit per employee from $4500 (50 percent of $6000 plus 25 percent of $6000) to $2400 (40 percent of $6000). The bill does not reduce, however, the credit presently allowed for wages of economically disadvantaged summer youth employees (85 percent of up to $3,000 of qualified first-years wages).

Third, under the bill, no wages are to be taken into account for credit purposes with respect to any individual if that individual is employed by the employer for less than 14 days.

The bill also extends the authorization for appropriations for administrative and publicity expenses to fiscal years 1986 and 1987.

Effective Date

The provision applies to taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $176 million in 1986, $424 million in 1987, $304 million in 1988, $67 million in 1989, and $13 million in 1990.

2. Extension of Tax Credit for Orphan Drug Clinical Testing (Sec. 283 of the bill and sec. 28 of the Code)

Present Law

A 50-percent, nonrefundable tax credit is allowed for a taxpayer's qualified clinical testing expenses paid or incurred in the testing of certain drugs ("orphan drugs") for rare diseases or conditions (Code sec. 28). A rare disease or condition is one that occurs so infrequently in the United States that there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS ("Lou Gehrig's disease"), Tourette's syndrome, and Duchenne's dystrophy, a form of muscular dystrophy.

Rare diseases in this program are identified by the Food and Drug Administration, which initially finances laboratory and small-scale clinical testing by independent researchers. These tests provide data which establish the basis for a research-oriented drug firm to decide to undertake more extensive testing. The tax credit is allowable for the more extensive testing.

Testing expenditures eligible for the 50-percent credit may not be expensed as research and experimental expenditures under section 174, without reduction for the amount of the credit. A taxpayer may not claim the 25-percent credit for incremental research activities (sec. 30) with respect to expenditures for which the orphan drug credit is claimed. Present law provides that the orphan drug credit will not be available for amounts paid or incurred after December 31, 1987.

Reasons for Change

The committee decided to extend the orphan drug credit for an additional year, to be consistent with the longer authorization period for research grants for development of vaccines or drugs to treat rare diseases. In addition, the committee extended several other tax credits through 1988, creating a uniform expiration date for many credits.

Explanation of Provision

The bill extends for one additional year the expiration date of the credit for clinical testing of orphan drugs, through December 31, 1988.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $8 million in 1988 and $7 million in 1989.

TITLE III—CORPORATE TAXATION

A. Corporate Tax Rates (Secs. 301 and 302 of the bill and secs. 11 and 1201 of the Code)

Present Law

Corporate tax rate generally

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000. The corporate taxable income brackets and tax rates are presented in the table, below.

PRESENT LAW CORPORATE TAX RATES

Taxable Income	Tax Rate (percent)
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	30
Over $75,000 but not over $100,000	40
Over $100,000	46

This schedule of corporate tax rates was enacted in the Economic Recovery Tax Act of 1981 (ERTA), effective for 1983 and later years. For 1982, the applicable rates were 16 percent for taxable income not over $25,000, and 19 percent for taxable income over $25,000 but not over $50,000. For taxable years after 1979 and before 1982, the rates were 17 percent and 20 percent, respectively.

An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $1 million. The maximum additional tax is $20,250. This provision phases out the benefit of graduated rates for corporations with taxable between $1 million and $1,405,000: corporations with taxable income in excess of $1,405,000, in effect, pay a flat tax at a 46-percent rate. This provision was enacted in the Deficit Reduction Act of 1984, effective for taxable years beginning after 1983.[1]

[1] Rules are provided to prevent the benefits of graduated rates from being proliferated through the use of multiple commonly controlled corporations (secs. 1551, 1561-1564). Other statutory provisions attempt to limit the use of corporations to avoid individual tax rates. These are principally the accumulated earnings tax (secs. 531 et seq.), the personal holding company tax (secs. 541 et seq.), and certain personal service corporation provisions (sec. 269A).

Corporate capital gains tax rate

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax (sec. 1201). Corporate capital losses are deductible only against capital gain. Capital losses generally can be carried back 3 years and forward 5 years.

Reasons for Change

One of the most important objectives of the bill is to reduce marginal tax rates on income earned by individuals and businesses. Lower tax rates promote economic growth by increasing the rate of return on investment. Lower tax rates also improve the allocation of resources within the economy by reducing the impact of tax considerations on the choice between alternative investments. In addition, lower tax rates promote compliance by reducing the potential gain from engaging in transactions designed to avoid or evade income tax. The bill achieves this objective by reducing the top corporate rate from 46 to 36 percent.

The committee retained graduated rates for small corporations. The present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses. In many provisions of the bill, the committee has found it appropriate to provide special relief to small business. However, the committee more narrowly targeted the beneficiaries of this provision by phasing out the benefit of graduated rates for corporations with taxable income in excess of $365,000, as compared to $1,405,000 under present law. In addition, the committee simplified the present graduated rate structure for corporations by reducing the number of brackets from 5 to 3.

Under present law, large corporations obtain preferential treatment of capital gains income (28-percent alternative rate compared to 46-percent regular rate). The committee is of the view that corporate capital gain should not be taxed at preferential rates. Thus, the bill conforms the corporate capital gains rate with the regular tax rate for large corporations.

Explanation of Provision

Corporate tax rate schedule

Under the bill tax would be imposed on corporations under the schedule shown in the following table.

CORPORATE TAX RATES IN BILL

Taxable Income	Tax Rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000	36

An additional 5-percent tax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $13,250. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $365,000; corporations with income in excess of $365,000, in effect, will pay a flat tax at a 36-percent rate.

Corporate capital gains

The alternative tax rate for net capital gains of corporations is increased to 36 percent—the top corporate tax rate for ordinary income. Present law limitations on the deduction of capital losses are retained.

Effective Date

The revised corporate tax rates are effective for taxable years beginning on or after July 1, 1986. Thus, the rate schedule for taxable years including July 1, 1986 will reflect blended rates based on the new rates effective on such date (see sec. 15).

The increase in the alternative tax rate on corporate capital gain generally is effective for tax years ending after December 31, 1985. Under a transition rule, the 28-percent rate would be retained for "pre-1986" net capital gain. Pre-1986 net capital gain is measured as the lesser of: (1) net capital gain for the taxable year; and (2) net capital gain attributable to dispositions of property on or before September 25, 1985 (or pursuant to a written binding contract in effect on that date) or that is included in income under the taxpayer's method of accounting, before January 1, 1986. The effect of this transition rule generally is to tax, at a 28-percent maximum rate, net gain recognized before 1986 or pursuant to a binding contract in effect on September 25, 1985. The effect of limiting pre-1986 net capital gain to the net capital gain for the taxable year is to stack post-1986 capital losses first against capital gain still eligible for the 28-percent maximum rate.

Under a transition rule, the capital gains rate applicable to timber, coal, and domestic iron ore royalties is phased up to 30 percent for tax years beginning in 1986, 31 percent in 1987, 32 percent in 1988, and 36 percent for tax year beginning in or after 1989 (see sec. 243 of the bill).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $5,186 million in 1986, $15,691 million in 1987, $21,181 million in 1988, $22,382 million in 1989, and $23,352 million in 1990.

B. Dividends Paid Deduction (Sec. 311 of the bill and secs. 231-234 of the Code)

Present Law

In general

Under present law, corporations and their shareholders generally are treated as separate taxable entities. Subject to certain exceptions, the corporation's taxable income is subject to a corporate income tax; then dividends distributed to individual shareholders are taxable as ordinary income.[2] Thus, corporate income that is distributed as dividends to shareholders generally is subject to two tiers of taxation.

In contrast, amounts distributed by a corporation as interest payments to creditors rather than as dividends to shareholders generally are not taxed at the corporate level, since the corporation generally may deduct interest payments from its taxable income (sec. 163). In addition, since no income tax generally is imposed at the shareholder level with respect to corporate income prior to its distribution, corporate income that is not distributed to shareholders is subject to current tax at the corporate level only.[3] Further, income earned outside of corporate solution is subject to only one level of tax.

Corporate income not subject to two tier taxation

Income earned by certain corporations is not subject to the general regime of two tier taxation of corporate earnings. Such corporations are corporations electing under subchapter S ("S Corporations") (secs. 1361 *et seq.*), regulated investment companies ("RICs") (secs. 851 *et seq.*), real estate investment trusts ("REITs") (secs. 856 *et seq.*), and cooperatives subject to subchapter T of the Code (secs. 1381 *et seq.*).

S corporations are corporations that meet restrictions on the number of shareholders as well as certain other requirements, and that also elect special treatment under subchapter S. RICs and REITs are entities that derive a substantial portion of their income from essentially passive investments and that absent special provisions in the Code otherwise would be taxed as ordinary corporations. Cooperatives generally are corporations that either market

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[2] Distributions with respect to stock that exceed corporate earnings and profits (see sec. 312) are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock (sec. 301(c)). Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly may be taxed to the shareholder at capital gains rates (*id.*).

[3] Certain Code provisions are designed to prevent unreasonable accumulations of corporate earnings (sec. 531 *et seq.*) or to cause the distribution of corporate earnings of "personal holding companies" to shareholders (sec. 541 *et seq.*).

products or purchase goods for its members, or that otherwise are operated on a cooperative basis.

Income earned by an S corporation is allocated among and taxed directly to its shareholders regardless of whether such income is distributed. Income earned by a RIC or a REIT is subject to a tax at the corporate level, but both RICs and REITs are permitted deductions for dividends paid, in effect eliminating the corporate tax on earnings that are distributed. Moreover, in order to maintain the status of a RIC or a REIT, such entities are required to distribute most of their income currently.

Cooperatives generally are subject to tax at the corporate level but may exclude from income the amount of dividends paid out of profits derived from transactions with their members. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates. As a result, cooperatives generally pay corporate tax only on profits that are not distributed or otherwise allocated to shareholders, and on profits not derived from transactions with members.[4] Cooperative members who receive dividends or have other amounts paid or allocated to them generally treat such amounts as income, reduction of basis, or some other characterization that is appropriate based on the nature of the members' transactions with the cooperative.

Distributions to foreign shareholders

Dividends paid by a U.S. corporation to foreign shareholders generally are subject to a 30 percent tax (secs. 861, 871, 881), which the distributing corporation (or appropriate agent) is required to withhold (secs. 1441, 1442). The rate of the U.S. tax may be substantially reduced pursuant to various income tax treaties, however.

A portion of dividends paid by a foreign corporation to its foreign shareholders is also subject to the U.S. tax (and the withholding requirement) if at least 50 percent of the foreign corporation's income earned in a specified period is effectively connected with the conduct of a trade or business within the United States. The portion of the dividend that is subject to the U.S. tax is that portion of the dividend that bears the same ratio to the total dividends paid that the foreign corporation's income effectively connected with its U.S. trade or business bears to its total income (see sec. 861(a)(2)(B)).

Distributions to tax-exempt shareholders

In general, an organization exempt from tax under section 501 of the Code has no tax liability on account of dividends received. However, such a tax-exempt entity generally is subject to tax on its "unrelated business income" (sec. 511). In addition, for such an entity, dividend income derived from "debt-financed property" is treated as taxable unrelated business income (sec. 514).

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[4] In addition, tax-exempt farmers' cooperatives qualifying under section 521(b) of the Code may exclude the amount of such distributions or allocations to the full extent of their net income and also may exclude, to a limited extent, dividends on common stock.

Policyholder dividends paid by mutual life insurance companies

Under present law, the deduction for policyholder dividends of mutual life insurance companies is reduced by an amount referred to as the differential earnings amount (sec. 809). Because a mutual company's policyholders are also the owners of the enterprise (which is not the case for stock companies, whose stockholders are its owners), the policyholder dividends paid represent, in part, a return of the company's profits. The differential earnings amount generally is the measure of the amount that is a distribution of profits to the policyholders as owners.

The differential earnings amount is determined by multiplying a company's average equity base for the taxable year by the differential earnings rate for the taxable year. The computation of such amount takes into account the fact that policyholder dividends generally are not includible in policyholders' income. The differential earnings amount for any taxable year is recomputed when sufficient tax return information is available to determine the average mutual earnings rate for the calendar year in which the taxable year begins. If the recomputed differential earnings amount computed with respect to a given taxable year exceeds or is less than the differential earnings amount reported on the company's tax return for that year, then the difference is includable (or deductible) in the succeeding taxable year.

Reasons for Change

The committee believes that the general imposition of a two-tier tax on corporate income distributed to shareholders as dividends may tend to create certain distortions in economic decisions relating to whether a business is operated in corporate or non-corporate form, whether an incorporated business uses debt or equity financing, and whether corporate earnings are retained or distributed. The committee believes that granting a deduction for a portion of dividends paid may help to reduce these distortions.

Since such distortions occur only to the extent that corporate tax is borne by a corporation, the committee believes that the deduction should be limited to distributions of earnings that have borne a corporate level tax. Moreover, since the income of certain corporations is generally not subject to two tiers of tax (e.g., S corporations and cooperatives), the committee does not believe that it would be appropriate to extend any relief to such corporations.

Further, the committee believes that, to the extent mutual life insurance company policyholder dividends represent nondeductible distributions of earnings that have been subject to tax at the corporate level, an appropriate portion of such policyholder dividends should be eligible for a deduction equivalent to the deduction for dividends paid out of such earnings available to stock companies. Therefore, the committee has added a provision intended to accomplish this result.

Nevertheless, the committee believes that the granting of a dividends paid deduction should not have the effect of lowering the total tax collected on income earned through U.S. corporations by foreign persons (not subject to U.S. tax), particularly where the foreign county may unfairly discriminate against the U.S. in granting

similar relief from a two-tier tax system, or where the foreign country does not cooperate with the U.S. to prevent treaty shopping. Thus, the committee bill imposes a compensatory withholding on dividends paid to foreign shareholders in certain circumstances.

The committee also believes that the dividends paid deduction should not have the effect of eliminating completely the tax on business income. Thus, the committee bill treats a portion of dividends paid to significant tax-exempt shareholders as taxable unrelated business income where the dividends are eligible for the deduction.

Explanation of Provision

In general

The committee bill adds new sections 231 through 234 to the Code. Under these new provisions, which are phased in over ten years, a domestic corporation generally is entitled to a deduction equal to 10 percent of its dividends paid from earnings that have been subject to tax at the corporate level. The deduction is not available to regulated investment companies, real estate investment trusts, S corporations, cooperatives subject to subchapter T, DISCs or FSCs. Distributions in redemption of stock (including transactions deemed to be redemptions under section 304), in liquidation, or in a reorganization are not eligible for the dividends paid deduction regardless of whether any portion of the distribution is treated as a dividend distribution to which section 301 applies.

Under the committee bill, the dividends paid deduction is treated like an ordinary business deduction for the purpose of determining the corporation's income tax liability, including the liability for estimated tax payments. The dividends paid deduction does not, however, reduce earnings and profits, which is otherwise reduced by the full amount of a dividend, whether or not deductible. Net operating losses attributable to the dividends paid deduction are available to be carried back and forward to the extent permitted for net operating losses generally under present law.

The qualified dividend account

Under the committee bill, dividends are eligible for the dividends paid deduction only to the extent that such dividends do not exceed the amount of a "Qualified Dividend Account" ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax, less the amount of deductible dividends paid.

At the end of each taxable year, a corporation adds to its QDA its "adjusted taxable income" for the year. Adjusted taxable income generally is equal to the taxpayer's taxable income (i.e., gross income less deductible expenses), with certain adjustments that are intended to ensure that the QDA properly reflects the amount of earnings on which a corporate tax has been paid.

Accordingly, the following adjustments are made to taxable income in arriving at the adjusted taxable income. First, taxable income is computed without regard to the dividends paid deduction. Second, taxable income is reduced by the "deduction equivalent" of any available credit (including the foreign tax credit),

other than the credit under section 34 (relating to credits for certain uses of gasoline and special fuels) (i.e., amounts on which no corporate tax was paid as a result of such credits). Third, taxable income is increased by the amount of any 70 percent or 90 percent dividends received deduction.[5] Finally, to reflect the payment of any minimum tax, which is based on an alternative computation of taxable income, an amount equal to 100/36ths of the minimum tax liability is added to taxable income; the amount of this adjustment is made in the subsequent taxable year, however.[6]

For example, suppose a U.S. corporation had $200,000 of gross income from operations, $100,000 of deductions, and $50,000 of tax-exempt interest income. Some or all of the deductions are attributable to tax preference items. The corporation's initial tax liability (assuming a flat 36 percent rate) would be $36,000 (i.e., net taxable income of $100,000 times 36 percent). Assume the amount of tax the corporation ultimately pays is $21,800 after applying a $10,000 R & D credit and a $6,000 foreign tax credit, but adding an additional $1,800 minimum tax liability. The corporation would add $55,556 to its QDA at the end of its taxable year, an amount which is equal to the $100,000 total of the corporation's taxable income less the amount that if granted to the corporation as a deduction would yield the same tax benefit as the $16,000 in credits that the corporation used to reduce its tax liability (i.e., $16,000 divided by .36). In the following taxable year, the corporation would add to its adjusted taxable income an additional $5,000 (i.e., $1,800 divided by .36) to reflect the minimum tax liability.

The amount of dividends paid in a taxable year is deducted from the balance of the QDA as of the end of the taxable year, except to the extent that the balance in the QDA would be reduced below zero. Dividends in excess of the QDA as of the end of the taxable year in which the dividends were paid are not deductible. Moreover, such "excess dividends" may not be carried forward and deducted after amounts are added to the QDA in subsequent years.

In the event of an adjustment to any element of the corporation's adjusted taxable income for a taxable year (whether by reason of any carryback to such year or otherwise), the adjustment is treated as having been made as of the end of such taxable year. For exam-

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[5] The dividends received deduction is discussed in Part C, below. In general, dividends are eligible for the 90 percent dividends received deduction only in cases where the payor is entitled to a dividends paid deduction. Hence, the income represented by such a dividend has been subject to one corporate level tax. Inclusion of the full amount of the dividend in the QDA of the recipient in effect allows the recipient to offset the income tax paid on its receipt of the dividend with a corresponding dividends paid deduction upon distribution of such amounts. Thus, on eventual distribution to noncorporate shareholders, such corporate earnings will have been subject to no more than one corporate level tax as diminished by a single 10 percent dividends paid deduction. The adjustment is also made in the case of dividends eligible for the 70 percent dividends received deduction even though there is no similar assurance that the dividend was eligible for the dividends paid deduction; this adjustment is allowed in order not to penalize unduly the recipient corporation.

[6] The addition is made in the subsequent taxable year in order to avoid the situation that would exist where the minimum tax liability for a taxable year depended on the amount of the dividends paid deduction for that year, while the dividends paid deduction deduction for the same year depended on the minimum tax liability. By making the adjustment resulting from the minimum tax liability in the subsequent year, the current year's minimum tax liability does not have an impact on the current year's dividends paid deduction. Moreover, in order to avoid a similar situation where the amount of a deduction depends on the taxpayer's taxable income, the committee bill provides that for purposes of sections 246(b), 613, 613A, and 593, taxable income is determined without regard to the dividends paid deduction.

ple, suppose a calendar year corporation has a total QDA of $100 at the end of 1988 after adding adjusted taxable income of $100 for that year, and before deducting the amount of any dividends paid. The corporation paid $100 of dividends during the year and, accordingly, took a $1 dividends paid deduction. In 1989 the corporation suffers a $100 net operating loss that is carried back to 1988. Since this adjustment is treated as having been made in 1988, the corporation's dividends paid deduction for that year would be disallowed since its QDA at the end of the year (before reduction for dividends paid) would have been reduced to zero.

The QDA is treated as a carryover item under section 381 in certain merger or acquisition transactions. In the case of complete liquidations (other than liquidations of controlled subsidiaries under section 332), a corporation's QDA is eliminated completely. In the case of redemptions or partial liquidations, the QDA is reduced proportionately with the amount of stock redeemed or portion of the stock liquidated, but not in excess of the amount of redemption or liquidation proceeds distributed to shareholders. This is analogous to the treatment of the earnings and profits account upon redemptions or partial liquidations (sec. 312(h) and sec. 312(n)(7)).

Treatment of foreign corporations and foreign shareholders

Foreign corporations

Under the committee bill, a foreign corporation is entitled to the dividends paid deduction in certain circumstances. To be eligible for the dividends paid deduction, a foreign corporation must meet the requirements of section 245(a), regarding whether the dividends it pays are eligible for any dividends received deduction. Thus, certain foreign corporations, at least 50 percent of whose income is effectively connected with a U.S. trade or business, may receive the dividends paid deduction. The deduction is available, however, only with respect to a pro rata portion of the dividends paid, i.e., that portion which bears the same ratio to the dividends paid as the corporation's income effectively connected with a U.S. trade or business bears to its total income as computed for purposes of section 245(a).

Foreign shareholders

Under the committee bill, a corporation is entitled to the dividends paid deduction without regard to whether the dividends are paid to domestic or foreign shareholders. However, the committee bill adds new section 898 to the Code, which imposes an additional tax on dividends paid to foreign shareholders in certain circumstances. Under new section 898, a tax in addition to that imposed by sections 871 or 881, is imposed on dividends received from sources within the United States by a nonresident alien or foreign corporation. The tax is subject to the withholding requirements of section 1441 or 1442, whichever is applicable.

The amount of tax imposed under section 898, is equal to the percentage dividends paid deduction that would be allowed to the payor for the taxable year in which it pays the dividend, times the top corporate income tax rate. Thus, when the dividends paid deduction is fully phased in, the additional withholding tax would be

equal to 3.6 percent of the amount of dividends. The tax is imposed whether or not the dividends paid deduction is actually allowed with respect to the dividends paid.

The additional tax under 898 generally is imposed on all foreign shareholders regardless of whether any treaty provides a limit on the amount of tax to which the foreign shareholder may be subject. However, the additional tax is not imposed on dividends paid to foreign shareholders if at the time such dividends are paid, there is an income tax treaty in effect between the U.S. and the recipient shareholder's country that would prevent the imposition of the additional tax, and there is also in effect a certification by the Secretary of the Treasury that (a) such treaty has adequate provisions to prevent treaty shopping, and (b) if such country has a two-tier tax on corporate income similar to that of the U.S., and such country grants relief from such tax to national shareholders, that it also grants to U.S. shareholders relief equivalent to that provided by the dividends paid deduction.

Distributions to tax-exempt shareholders

Under the committee bill, a portion of dividends paid to certain tax-exempt entities, with respect to which the payor is entitled to a dividends paid deduction, is treated as "unrelated business income" that is subject to tax under section 511 of the Code. The shareholders whose dividends are so treated are organizations exempt from tax under section 501, that own five percent or more (by value) of the outstanding stock of a corporation, or stock possessing five percent or more of the total combined voting power of all stock of the corporation. The stockholdings of certain related tax-exempt entities are aggregated for this purpose.

The portion of such dividends that is treated as unrelated business income is the portion that bears the same ratio to the dividends received that the amount of dividends paid by the corporation in the taxable year with respect to which the dividends paid deduction is allowable to the payor corporation bears to the total dividends paid. Thus, the recipient five-percent tax-exempt shareholder must determine whether and to what extent the payor corporation is entitled to the dividends paid deduction with respect to its distributions during the year. In addition, during the phase-in period, the recipient shareholder must determine the taxable year of the distributing corporation in order to determine the appropriate percentage of the dividend to include in income.

Under the committee bill, whether dividends received by a five-percent tax-exempt shareholder are subject to the tax is determined solely on the basis of the dividends paid deduction that is allowable based on the return filed by the payor corporation for the year that the distribution was made.[7] Thus, if a payor corporation initially claims a dividends paid deduction with respect to the dividends paid to the five-percent tax-exempt shareholder, but the deduction is later disallowed or not claimed, whether on account of

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[7] The committee intends that taxpayers may not take advantage of this rule by failing to claim any dividends paid deduction on the taxpayer's original return, but then claiming the deduction on an amended return. For this purpose, the dividends paid deduction that would have been allowable, rather than the deduction claimed on such return, determines the amount of unrelated business income for five-percent tax-exempt shareholders.

the filing of an amended return, the making of an audit adjustment, or the carryback of net operating losses, there would be no adjustment of the tax liability of the recipient shareholder.[8]

Source rules

The committee intends that the dividends paid deduction is to be allocated between U.S. and foreign source income and that the Secretary of the Treasury will provide appropriate regulations relating to the exact method of allocation. The committee anticipates that the allocation to a particular source generally is to be proportionate to the amount of earnings from the particular source in the QDA out of which the dividend was paid. The committee intends that these regulations would properly account for the source of adjustments made to taxable income in arriving at adjusted taxable income; for example, the amount by which the QDA is reduced on account of the foreign tax credit should be allocated entirely to foreign source income since this adjustment is attributable only to such income. Moreover, the committee intends that the allocation of the source of a a dividend is to be made for this purpose on an aggregate, rather than a year-by-year basis.

Policyholder dividends by mutual life insurance companies

Under the committee bill, a portion of the policyholder dividends paid by a mutual life insurance company is treated as a dividend that is eligible for the 10 pecent dividends paid deduction. For this purpose, the portion of such policyholder dividends treated as a dividend eligible for the 10 percent deduction for any taxable year is 80 percent of the differential earnings amount for the taxable year. The committee intends that such portion of policyholder dividends is eligible for the dividends paid deduction only if all other requirements for the deduction are met (e.g., sufficient amounts in the QDA). Moreover, all other provisions of the committee bill relating to the dividends paid deduction, such as the additional tax under section 898, also apply with respect to the deduction for the portion of policyholder dividends treated as dividends eligible for the 10 percent deduction. Under the committee bill, the Secretary of the Treasury is authorized to prescribe regulations applying rules regarding the dividends paid deduction for mutual life insurance companies, including rules with respect to the treatment of an appropriate portion of the recomputed differential earnings amount as an adjustment to the amount treated as dividends paid by such companies.

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[8] Where the shareholder files its tax return for the year in which it received a dividend prior to the time that the payor files a return for the taxable year in which it paid such dividend (which may occur because the payor's taxable year does not coincide with the taxable year of the recipient), it may not be known at the time whether the payor corporation would be entitled to any dividends paid deduction since its taxable income (and accordingly the amount of the adjustment to the QDA) would not then be known. In this situation, the committee intends that the shareholder would be subject to the unrelated business tax initially, but would be entitled to a refund to the extent that it is later determined that the payor was not entitled to the deduction.

Effective Date

The dividends paid deduction generally is effective for dividends paid in taxable years of the payor beginning after January 1, 1987. However, the deduction is phased in over ten years, so that in taxable years beginning after January 1, 1987 and before January 2, 1988, the dividends paid deduction is equal to one percent of dividends paid. The deduction is increased in one percentage point increments in the succeeding nine years, so that in taxable years beginning after January 1, 1996, the deduction is equal to 10 percent.

The additional tax on dividends paid to certain foreign shareholders generally is imposed on dividends paid after December 31, 1987. However, for foreign shareholders who are otherwise entitled to a lower rate under a treaty, and not eligible to be excepted from the additional tax, such tax is imposed only on dividends paid after December 31, 1988. This tax is also phased in to coincide with the dividends paid deduction available to the payor.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts in 1986, and is estimated to decrease fiscal year budget receipts by $32 million in 1987, $306 million in 1988, $775 million in 1989, and $1,238 million in 1990.

C. Dividends Received Deduction (Secs. 303 and 312 of the bill and secs. 243-246A of the Code)

Present Law

Under present law, corporations that receive dividends generally are entitled to a deduction equal to 85 percent of the dividends received (sec. 243(a)(1)). Dividends received from a small business investment company operating under the Small Business Investment Act of 1958 (sec. 243(a)(2)), and "qualifying dividends" received from certain members of an affiliated group are eligible for a 100 percent dividends received deduction (sec. 243(a)(3)). In addition, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed currently to the recipient (Treas. Reg. sec. 1.1502-14).

In general, dividends received by a U.S. corporation from a foreign corporation are not eligible for the dividends received deduction, even though the foreign corporation may have paid U.S. income tax. However, a portion of the dividends paid by such corporation to a U.S. corporate shareholder is eligible for the dividends received deduction, where at least 50 percent of a foreign corporation's gross income is effectively connected with a U.S. trade or business during an uninterrupted period of 36 months ending with the close of the year in which the dividends are paid (or for the period of the corporation's existence, if shorter). That portion generally is based on the percentage of the foreign corporation's income that is effectively connected with its U.S. trade or business (sec. 245).

Where a foreign corporation is wholly owned by a U.S. corporation and all of its income is effectively connected with a U.S. trade or business, dividends paid by such corporation generally are eligible for a 100 percent dividends received deduction. In addition, certain dividends paid by a corporation that is or was a foreign sales corporation also are eligible for a 100 percent dividends received deduction.

The dividends received deduction does not apply to certain dividends, including dividends received from a thrift institution that was entitled to a deduction under section 591 for dividends paid (sec. 243(c)(1)), dividends received from a REIT (sec. 243(c)(3)), dividends on certain public utility preferred stock (sec. 243(c)(4)), dividends received from certain corporations that were exempt from tax under section 501 or section 521 in the year of the distribution or the preceding year (sec. 246(a)(1)), and certain dividends received from a Federal Home Loan Bank Bank (sec. 246(a)(2)). The availability of the dividends received deduction is limited with respect to dividends received from a RIC (sec. 243(c)(2)).

The dividends received deduction is also not available with respect to dividends received on stock that is not held (with a substantial risk of loss) for a specified period, generally more than 45 days (90 days in the case of certain preferred stock)(sec. 246(c)), dividends from a DISC or former DISC (sec. 246(d)), and certain dividends distributed pursuant to the provisions of section 936 of the Code (relating to the Puerto Rico and possessions tax credit) (sec. 243(e)). The deduction is also limited for dividends received on certain "debt-financed portfolio stock" (sec. 246A) and for dividends received by certain thrift institutions that compute bad debt reserves under the percentage of income method (sec. 596). In addition, there is an overall limit on the availability on the dividends received deduction generally equal to 85 percent of the recipient's taxable income subject to certain adjustments (sec. 246(b)).

Reasons for Change

Under present law, dividends eligible for the 85 percent dividends received deduction are taxed at a maximum rate of 6.9 percent (15 percent of the top corporate rate of 46 percent). The committee does not believe that a reducton in this effective rate is warranted. Thus, the dividends received deduction has been reduced to 80 percent, resulting in a maximum rate of 7.2 percent of dividends subject to the reduced top corporate rate (20 percent of the top corporate rate of 36 percent. Further, the committee recognizes that the implementation of a dividends paid deduction requires certain adjustment to the dividends received deduction. In addition, the committee believes that the distinction between direct and portfolio investment with regard to the dividends received deduction should be preserved, and the deduction should be more generous for the former than the latter.

Explanation of Provision

In general

Under the committee bill, the 85 percent dividends received deduction is lowered to 80 percent. In addition, after a phase in period, a corporation that receives dividends eligible for a dividends received deduction under present law generally is entitled either to a 100 percent, a 90 percent, or a 70 percent dividends received deduction. Generally, the shareholder's dividends received deduction depends on whether or not the dividend is received from an affiliated corporation (as defined in section 243(b)(5)), and if so, whether the affiliate was entitled to a dividends paid deduction. The provisions of the committee bill are phased in in a manner that roughly corresponds to the phase-in of the dividends paid deduction.

Dividends from affiliates

Under the committee bill, as fully phased in, where a corporate shareholder receives a qualifying dividend from an affiliate that would be eligible for the 100 percent dividends received deduction under present law, and the payor corporation is entitled to a dividends paid deduction with respect to such dividend, the shareholder is entitled to a 90 percent dividends received deduction. Where a

corporate shareholder receives such a qualifying dividend and no dividends paid deduction is available with respect to such dividend (because the distributing corporation did not pay any corporate tax on the distributed earnings), the recipient shareholder is entitled to a 100 percent dividends received deduction under the bill.[9]

To comply with these rules, the shareholder corporation must determine the amount of the dividends it received with respect to which a dividends paid deduction was allowed to the payor corporation.[10]

Dividends from non-affiliates

Under the committee bill, dividends eligible for the 85 percent dividends received deduction under present law are eligible for an 80 percent dividends received deduction at the beginning of a phase in period. During the phase in period, the deduction is decreased to 70 percent of dividends received. Further, under the committee bill as fully phased in, a corporation that receives a dividend from a small business investment company, which dividend would be eligible for the 100 percent dividends received deduction under present law section 243(a)(2), is entitled to a 90 percent dividends received deduction. The percentage of the dividends received deduction in either case does not vary depending on whether the payor received any dividends paid deduction.

Limitations

The committee bill does not alter any of the provisions of present law that limit or deny the dividends received deduction in certain circumstances (e.g., sec. 246). Accordingly, in such circumstances, the full amount of the dividend would be taken into account in computing the recipient corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder, and no special rules would be used to compute the amount to be added to the shareholder's QDA. The payor corporation, if otherwise eligible, remains entitled to the 10 percent deduction for the dividend paid, however.

Effective Date

The provision of the committee bill lowering the dividends received deduction for dividends other than qualifying dividends or dividends from a small business investment company, from 85 percent to 80 percent is effective for dividends received or accrued after December 31, 1985. The committee bill reduces the 80 percent dividends received deduction to 70 percent over a nine-year phase in period beginning with dividends received in 1988. Accordingly, the deduction is 79 percent for dividends received or accrued in 1988 and is decreased by one percentage point in each of the nine succeeding calendar years, so that the deduction is 70 percent for

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[9] Similar rules are provided for dividends eligible for the 100 percent dividends received deduction under section 245(b) of present law.

[10] Where there are operating loss carrybacks or other subsequent year adjustments (such as audit adjustments) that retroactively reduce (or increase) the QDA and reduce (or increase) a payor corporation's dividends paid deduction, such adjustments could retroactively affect a recipient corporation's dividends received deduction.

dividends received after December 31, 1996. The dividends received deduction for dividends received from a small business investment company is reduced from 100 percent to 90 percent over the same ten-year phase in period.

The provision of the committee bill modifying the dividends received deduction for qualifying dividends (and for dividends eligible for the the dividends received deuction under section 245(b)) generally is effective for taxable years of the payor corporation beginning after January 1, 1987 and is phased in over a ten-year period corresponding to the phase in of the dividends paid deduction. The phase in of this provision is based on the taxable year of the payor and the percentage dividends paid deduction the payor is entitled to with respect to the dividend. Thus, for example, the dividends received deduction for qualifying dividends from affiliates with respect to which the payor receives a one percent dividends paid deduction in its taxable year ending June 30, 1988, is 99 percent. As the dividends paid deduction increases in one percent increments in subsequent taxable years, the dividends received deduction for such qualifying dividends in each case decreases in one percent increments, until the dividends paid deduction has been fully phased in at 10 percent and the dividends received deduction reduced to 90 percent.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $139 million in 1986, $224 million in 1987, $252 million in 1988, $311 million in 1989, and $373 million in 1990.

D. Dividend Exclusion for Individuals (Sec. 313 of the bill and sec. 116 of the Code)

Present Law

Under present law, the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income (sec. 116(a)).

The dividends exclusion for individuals does not apply to dividends received from an organization that was exempt from tax under section 501 or a tax-exempt farmers' cooperative in either the year of distribution or the preceding year (sec. 116(b)(1)), dividends received from a REIT (sec. 116(b)(2)), dividends received from a mutual savings bank that received a deduction for the dividend under section 591 (sec. 116(c)(1)), or to an ESOP dividend for which the corporation received a deduction (sec. 116(e)). The exclusion is limited with respect to dividends received from a RIC (sec. 116(c)(2)).

Reasons for Change

The committee believes that the dividend exclusion for individuals under present law provides little relief from the two-tier tax corporate income because of the law limitation, tends to benefit high-bracket taxpayers more than low-bracket taxpayers, is made unnecessary because of the new dividends paid deduction, and is thus inappropriate to retain in conjunction with tax reform efforts intended to broaden the income tax base and lower tax rates.

Explanation of Provision

Under the committee bill, the limited dividend exclusion for individuals is repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $199 million in 1986, $558 million in 1987, $597 million in 1988, $625 million in 1989, and $659 million in 1990.

E. Treatment of Stock Redemption Expenses (Sec. 314 of the bill and sec. 162 of the Code)

Present Law

A deduction is allowed for all ordinary and necessary business expenses incurred during the taxable year in carrying on a trade or business (sec. 162(a)). No current deduction is allowed, however, for the costs of acquiring property whose life extends substantially beyond the close of the taxable year, which must be capitalized (sec. 263).

The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital transaction that does not give rise to a current deduction. Although one case suggests that in certain extraordinary circumstances amounts paid by a corporation to repurchase its stock may be fully deductible under section 162,[11] subsequent cases have strictly limited the holding in that case to its peculiar facts, with the result that no deduction was allowed.[12] Furthermore, the validity of this case has been questioned.[13]

The Supreme Court has held that the requirement that stock redemption expenses be capitalized extends not only to amounts representing consideration for the stock itself, but also to expenses such as legal, brokerage, and accounting fees incident to the acquisition.[14]

Reasons for Change

The committee understands that some corporate taxpayers are taking the position that expenditures incurred to repurchase stock from stockholders to prevent a hostile takeover of the corporation by such shareholders — so-called "greenmail" payments — are deductible business expenses. The committee wishes to clarify that all expenditures by a corporation incurred in purchasing its own stock, whether representing direct consideration for the stock, a premium payment above the apparent stock value, or costs incident to the purchase, are nonamortizable capital expenditures.

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[11] *Five Star Manufacturing Co.* v. *Comm'r*, 355 F.2d 724 (5th Cir. 1966), finding deductibility where it was shown that a liquidation of the corporation was imminent in the absence of the redemption, and no value would have been realized by the shareholders in the event of such a liquidation.

[12] *See, e.g., Jim Walter Corp.* v. *United States*, 498 F. 2d 631 (5th Cir. 1974); *Markham & Brown, Inc.* v. *United States*, 648 F.2d 1043 (5th Cir. 1981); *H. & G. Industries* v. *Comm'r*, 495 F.2d 653 (3d Cir. 1974); *Harder Services, Inc.* v. *Comm'r*, 67 T.C. 585 (1976), *aff'd without opinion* 573 F.2d 1290 (2d Cir. 1977).

[13] *See, e.g., Proskauer* v. *Comm'r*, 46 T.C.M. 679, 684 (1983), noting that the *Five Star* court may have applied the "primary purpose" standard that was often used in determining whether the expenditure was capital in nature before the Supreme Court's rejection of that standard in *Woodward*.

[14] *See Woodward* v. *Comm'r*, 397 U.S. 572 (1970); *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970).

Explanation of Provision

The bill provides that no deduction is allowed for any amount paid or incurred by a corporation in connection with the redemption of its stock.[15] The committee intends that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with the repurchase; and any other expenditure that is necessary or incident to the repurchase, whether representing costs incurred by the purchasing corporation or by the selling shareholder (and paid or reimbursed by the purchasing corporation), or incurred by persons or entities related to either. The provision is also intended to apply to any amount paid by a corporation to a selling shareholder (or any related person) pursuant to an agreement entered into as part of or in connection with a repurchase of stock, whereunder the seller agrees not to purchase, finance a purchase, acquire, or in any way be a party or agent to the acquisition of stock of the corporation for a specified or indefinite period of time (so-called "standstill" agreements).

In making this clarification, the committee does not intend to create any inference that the payments covered by this section would be deductible under present law.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

[15] This provision is not limited to hostile takeover situations but applies to any corporate redemption.

F. Special Limitations on Net Operating Loss and Other Carryforwards (Sec. 321 of the bill and secs. 382 and 383 of the Code)

Overview

Present Law

In general, a corporate taxpayer is allowed to carry a net operating loss ("NOL(s)") forward for deduction in a future taxable year, as long as the corporation's legal identity is maintained. After certain nontaxable asset acquisitions in which the acquired corporation goes out of existence, the acquired corporation's NOL carryforwards carry over to the acquiring corporation. Similar rules apply to tax attributes other than NOLs, such as net capital losses and unused tax credits. Historically, the use of NOL and other carryforwards has been subject to special limitations after specified transactions involving the corporation in which the carryforwards arose (referred to as the "loss corporation"). Present law also provides other rules that are intended to limit tax-motivated acquisitions of loss corporations.

Under present law, the operation of the special limitations on the use of carryforwards turns on whether the transaction that causes the limitations to apply takes the form of a taxable sale or exchange of stock in the loss corporation or one of certain specified tax-free reorganizations in which the loss corporation's tax attributes carry over to a corporate successor. After a purchase (or other taxable ownership change) of a controlling stock interest in a loss corporation, NOL and other carryforwards are disallowed unless the loss corporation continues to conduct its historic trade or business. In the case of a tax-free reorganization, NOL and other carryforwards are generally allowed in full if the loss corporation's shareholders receive stock representing at least 20 percent of the value of the acquiring corporation.

NOL and other carryforwards

Although the Federal income tax system generally requires an annual accounting, a corporate taxpayer is allowed to carry NOLs back to the three taxable years preceding the loss and then forward to each of the 15 taxable years following the loss year (sec. 172). The rationale for allowing the deduction of NOL carryforwards (and carrybacks) is that a taxpayer should be able to average income and losses over a period of years, to reduce the disparity between the taxation of businesses that have stable income and businesses that experience fluctuations in income.[16]

In addition to NOLs, other tax attributes eligible to be carried back or forward include unused investment tax credits (secs. 30 and

[16] H.R. Rep. No. 1337, 83d Cong., 2d sess. 27 (1954).

39), excess foreign tax credits (sec. 904(c)), and net capital losses (sec. 1212). Like NOLs, unused investment tax credits are allowed a three-year carryback and a 15-year carryforward. Subject to an overall limitation based on a taxpayer's U.S. tax attributable to foreign-source income, excess foreign tax credits are allowed a two-year carryback and a five-year carryforward. For net capital losses, generally, corporations have a three-year carryback (but only to the extent the carrybacks do not increase or create a NOL) and a five-year carryforward.

NOL and other carryforwards that are not used before the end of a carryforward period expire.

Carryovers to corporate successors

In general, a corporation's tax history (e.g., carryforwards and asset basis) is preserved as long as the corporation's legal identity is continued. Thus, under the general rules of present law, changes in the stock ownership of a corporation do not affect the corporation's tax attributes. Following are examples of transactions that effect ownership changes without altering the legal identity of a corporation:

(1) A taxable purchase of a corporation's stock from its shareholders (a "purchase"),

(2) A type "B" reorganization, in which stock representing control of the acquired corporation is acquired solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)),

(3) A transfer of property to a corporation after which the transferors own 80 percent or more of the corporation's stock (a "section 351 exchange"),

(4) A contribution to the capital of a corporation, in exchange for the issuance of stock, and

(5) A type "E" reorganization, in which investor interests (shareholders and bondholders) are restructured (sec. 368(a)(1)(E)).

Statutory rules also provide for the carry over of tax attributes (including NOL and other carryforwards) from one corporation to another in certain tax-free acquisitions in which the acquired corporation goes out of existence (sec. 381). These rules apply if a corporation's assets are acquired by another corporation in one of the following transactions:

(1) The liquidation of an 80-percent owned subsidiary (sec. 332),

(2) A statutory merger or consolidation, or type "A" reorganization (sec. 368(a)(1)(A)),

(3) A type "C" reorganization, in which substantially all of the assets of one corporation is transferred to another corporation in exchange for voting stock, and the transferor completely liquidates (sec. 368(a)(1)(C)),

(4) A "nondivisive D reorganization," in which substantially all of a corporation's assets are transferred to a controlled corporation, and the transferor completely liquidates (secs. 368(a)(1)(D) and 354(b)(1)),

(5) A mere change in identity, form, or place of organization of a single corporation, or type "F" reorganization (sec. 368(a)(1)(F)), and

(6) A type "G" reorganization, in which substantially all of a corporation's assets are transferred to another corporation pursuant to a court approved insolvency or bankruptcy reorganization plan, and stock or securities of the transferee are distributed pursuant to the plan (sec. 368(a)(1)(G)).

In general, to qualify an acquisitive transaction (including a B reorganization) as a tax-free reorganization, the shareholders of the acquired corporation must retain "continuity of interest." Thus, a principal part of the consideration used by the acquiring corporation must consist of stock, and the holdings of all shareholders must be traced. Further, a tax-free reorganization must satisfy a "continuity of business enterprise" rule. Generally, continuity of business enterprise requires that a significant portion of an acquired corporation's assets be used in a business activity (see Treas. reg. sec. 1.368-1(d)).

Acquisitions to evade or avoid income tax

The Secretary of the Treasury is authorized to disallow deductions, credits, or other allowances following an acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance (sec. 269). This provision applies in the following cases:

(1) where any person or persons acquire (by purchase or in a tax-free transaction) at least 50 percent of a corporation's voting stock, or stock representing 50 percent of the value of the corporation's outstanding stock;

(2) where a corporation acquires property from a previously unrelated corporation and the acquiring corporation's basis for the property is determined by reference to the transferor's basis; and

(3) where a corporation purchases the stock of another corporation in a transaction that qualifies for elective treatment as a direct asset purchase (sec. 338), a section 338 election is not made, and the acquired corporation is liquidated into the acquiring corporation (under sec. 332).

Treasury regulations under section 269 provide that the acquisition of assets with an aggregate basis that is materially greater than their value (*i.e.*, assets with built-in losses), coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive (Treas. reg. sec. 1.269-3(c)(1)).

Consolidated return regulations

To the extent that NOL carryforwards are not limited by the application of section 382 or section 269, after an acquisition, the use of such losses may be limited under the consolidated return regulations. In general, if an acquired corporation joins the acquiring corporation in the filing of a consolidated tax return by an affiliated group of corporations, the use of the acquired corporation's pre-acquisition NOL carryforwards against income generated by other members of the group is limited by the "separate return limitation year" ("SRLY") rules (Treas. reg. sec. 1.1502-21(c)). An acquired corporation is permitted to use pre-acquisition NOLs to offset its own income. Section 269 is available to prevent taxpayers from avoiding the SRLY rules by diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to a newly acquired corporation (*see* Treas. reg. sec. 1.269-3(c)(2), to the effect that the transfer of income-producing assets by a parent corporation to a loss subsidiary filing a separate return may be deemed to have tax avoidance as a principal purpose).

Applicable Treasury regulations provide rules to prevent taxpayers from circumventing the SRLY rules by structuring a transaction as a "reverse acquisition" (defined in regulations as an acquisition where the "acquired" corporation's shareholders end up

owning more than 50 percent of the value of the "acquiring" corporation) (Treas. reg. sec. 1.1502-75(d)(3)). Similarly, under the "consolidated return change of ownership" ("CRCO") rules, if more than 50 percent of the value of stock in the common parent of an affiliated group changes hands, tax attributes (such as NOL carryforwards) of the group are limited to use against post-acquisition income of the members of the group (Treas. reg. sec. 1.1502-21(d)).

Treasury regulations also prohibit the use of an acquired corporation's built-in losses to reduce the taxable income of other members of an affiliated group (Treas. reg. sec. 1.1502-15). Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(a)(2)). The built-in loss limitations do not apply unless, among other things, the aggregate basis of the acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeds the value of those assets by more than 15 percent.

Allocation of income and deductions among related taxpayers

The Secretary of the Treasury is authorized to apportion or allocate gross income, deductions, credits, or allowances, between or among related taxpayers (including corporations), if such action is necessary to prevent evasion of tax or clearly reflect the income of a taxpayer (sec. 482). Section 482 can apply to prevent the diversion of income to a loss corporation in order to absorb NOL carryforwards.

Libson Shops doctrine

In *Libson Shops* v. *Koehler*, 353 U.S. 382 (1957) (decided under the 1939 Code), the U.S. Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. The court denied NOL carryovers following the merger of 16 identically owned corporations (engaged in the same business at different locations) into one corporation, on the grounds that the business generating post-merger income was not substantially the same business that incurred the loss (three corporations that generated the NOL carryovers continued to produce losses after the merger).

There is uncertainty whether the *Libson Shops* doctrine has continuing application as a separate nonstatutory test under the 1954 Code. *Compare Maxwell Hardware Co.* v. *Commissioner*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B. 46, as modified by T.I.R. 773 (October 13, 1965), (indicating that *Libson Shops* may have continuing vitality where, *inter alia*, there is a shift in the "benefits" of an NOL carryover).[17]

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[17] The legislative history of the 1976 Act amendments to section 382—discussed below—specifically provides that *Libson Shops* has no application to years governed by these amendments. *See* S. Rep. No. 938, 94th Cong., 2d Sess. p. 206 (1976).

Present law special limitations

The application of the special limitations on NOL carryforwards is triggered by specified changes in stock ownership of the loss corporation (sec. 382). In measuring changes in stock ownership, section 382(c) specifically excludes "nonvoting stock which is limited and preferred as to dividends." Different rules are provided for the application of special limitations on the use of carryovers after a purchase and after a tax-free reorganization. Section 382 does not address the treatment of built-in losses.

If the principal purpose of the acquisition of a loss corporation is tax avoidance, section 269 could apply to disallow NOL carryforwards even if section 382 is inapplicable. Similarly, the SRLY rules could apply even if a transaction passes muster under section 382.

Taxable purchases

If the special limitations apply after a purchase, NOL carryforwards are disallowed entirely. The rule for purchases applies if (1) one or more of the loss corporation's ten largest shareholders increase their common stock ownership within a two-year period by more than 50 percentage points, (2) the change in stock ownership results from a purchase or a decrease in the amount of outstanding stock, and (3) the loss corporation fails to continue the conduct of a trade or business substantially the same as that conducted before the proscribed change in ownership (sec. 382(a)). An exception to the purchase rule is provided for acquisitions from related persons.

Tax-free reorganizations

After a tax-free reorganization to which section 382(b) applies, NOL carryovers are allowed in full so long as the loss corporation's shareholders receive stock representing 20 percent or more of the value of the successor corporation (and section 269 does not apply). For each percentage point less than 20 percent received by the loss corporation's shareholders, the NOL carryover is reduced by five percent (*e.g.*, if the loss corporation's shareholders receive 15 percent of the acquiring corporation's stock, 25 percent of the NOL carryover is disallowed). The reorganizations described in section 382(b) are those referred to in section 381(a)(2), in which the loss corporation goes out of existence and NOL carryforwards carry over to a corporate successor. Where an acquiring corporation uses stock of a parent corporation as consideration (in a triangular reorganization), the 20-percent test is applied by treating the loss corporation's shareholders as if they received stock of the acquiring corporation with an equivalent value, rather than stock of the parent corporation. An exception to the reorganization rule is provided for mergers of corporations that are owned substantially by the same persons in the same proportion (thus, the result in the *Libson Shops* case is reversed).

Bankruptcy proceedings and stock-for-debt exchanges

In the case of a G reorganization, a creditor who receives stock in the reorganization is treated as a shareholder immediately before the reorganization. Thus, NOL carryforwards are generally avail-

able without limitation following changes in stock ownership resulting from a G reorganization.

If security holders exchange securities for stock in a loss corporation, the transaction could qualify as an E reorganization or a section 351 exchange. If unsecured creditors (*e.g.*, trade creditors) exchange their debt claims for stock in a loss corporation, such creditors recognize gain or loss: (1) indebtedness of the transferee corporation not evidenced by a security is not considered as issued for property for purposes of section 351, and (2) the definition of an E reorganization requires an exchange involving stock or securities. Thus, a stock-for-debt exchange by unsecured creditors is treated as a taxable purchase that triggers the special limitation.

Transactions involving "thrifts"

The general rules apply to taxable purchases of stock in a savings and loan association or savings bank (referred to as a "thrift"). Thus, after an ownership change resulting from a taxable purchase, a thrift's NOL carryforwards are unaffected if the thrift continues its business.

Where the acquisition of a thrift results from a reorganization described in section 368(a)(3)(D)(ii),[18] depositors are treated as stockholders for purposes of the special limitations applicable to reorganizations (sec. 382(b)(7).

Special limitations on other tax attributes

Section 383 incorporates by reference the same limitations contained in section 382 for carryforwards of investment credits, foreign tax credits, and capital losses.

1976 Act amendments

The Tax Reform Act of 1976 extensively revised section 382 to provide more nearly parallel rules for taxable purchases and tax-free reorganizations and to address technical problems under present law. The 1976 Act amendments were to be effective in 1978; however, the effective date has been delayed several times. The 1976 Act amendments to the rule for purchases are scheduled to become effective for taxable years beginning after December 31, 1985. The amended reorganization rules are to apply to reorganizations pursuant to plans adopted on or after January 1, 1986.

Reasons for Change

The purpose of the deduction for NOL carryforwards is to average income and losses over a period of years, thereby providing relief from the consequences of strict annual accounting. When a corporation incurs NOLs, the corporation's shareholders are presented with an opportunity to use the NOLs to effect tax benefit transfers (similar to the "safe harbor leasing" transactions, discussed in note 20 below). This opportunity arises because, under

[18] Sec. 368(a)(3)(D)(ii) provides nonrecognition treatment to thrift reorganizations that would otherwise qualify as G reorganizations, provided the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC"), or an equivalent State authority certifies that the thrift is insolvent, cannot meet its obligations currently, or will be unable to meet its obligations in the immediate future (this rule is repealed by sec. 804 of the bill).

general Federal income tax rules, a corporation is treated as a separate taxpayer that is independent of its shareholders. In an extreme case, for example, a taxpayer could purchase the stock in a loss corporation, sell the corporation's assets back to the original shareholders, and then contribute assets comprising a new business to the corporation.[19] The result of this series of transactions would be the transfer of NOL carryforwards for use against another taxpayer's income.

The primary purpose of the special limitations on the use of NOL carryforwards is to restrict the function of carryforwards to that of an averaging device. This purpose is not well served by present law rules that present opportunities for tax benefit transfers.[20] The committee concluded that the special limitations on the use of NOL carryforwards should be revised to reduce the number of circumstances in which NOL carryforwards can be used as a device for transferring tax benefits.

The committee's amendments address three general concerns: (1) the approach of present law (viz., the disallowance or reduction of NOL and other carryforwards), which is criticized as being too harsh where there are continuing loss-corporation shareholders, and ineffective to the extent that NOL carryforwards may be available for use without limitation after substantial ownership changes, (2) the discontinuities in the present law treatment of taxable purchases and tax-free reorganizations, and (3) defects in the existing rules that present opportunities for tax avoidance.

General approach

After reviewing various options for identifying events that present the opportunity for a tax benefit transfer (e.g., changes in a loss corporation's business), the committee concluded that changes in a loss corporation's stock ownership continues to be the best indicator of a potentially abusive transaction. Thus, under the bill, the special limitations generally apply when shareholders who bore the economic burden of a corporation's NOLs no longer hold a controlling interest in the corporation. In such a case, the possibility arises that new shareholders will contribute income-producing assets (or divert income opportunities) to the loss corporation, and the corporation will obtain greater utilization of carryforwards than it could have had there been no change in ownership.

The committee was persuaded that the complete disallowance of losses after a change in ownership of less than 100 percent would be too harsh. On the other hand, the committee believed that reliance on continuity of shareholder interest to measure the extent to which NOL carryforwards may be used following an ownership change is improper and recognized that an approach that allows

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[19] These are the facts of *Alprosa Watch Corporation*, 11 T.C. 240 (1948), in which the U.S. Tax Court allowed the use of pre-acquisition NOLs to offset income attributable to the new business.

[20] In 1981, the Congress enacted the safe harbor leasing provisions to facilitate leasing as a device for transferring accelerated cost recovery deductions and investment tax credits among taxpayers. A year later, the safe harbor leasing provisions were repealed, primarily because of concerns about the ability of corporations to avoid their equitable share of taxes, the revenue implications of the safe harbor leasing provisions and maintaining popular confidence that the tax system is fair. The repeal of the safe harbor leasing provisions demonstrated a Congressional reluctance to permit the transfer of tax benefits through a transaction that takes the form of a business transaction.

NOL carryforwards to the extent of the loss-corporation shareholder's continuing interests, as was done in the 1976 Act amendments, would continue to present opportunities for tax avoidance and would otherwise be improper.

Example.—L corporation has $2 million of business assets (a bread factory) and a $20 million NOL carryforward. P Corporation has pre-tax income of $1 million a year and an annual tax bill of $460,000. L is merged (in a tax-free transaction) into P, with L shareholders receiving 20 percent of P's stock. Under the 1976 Act amendments, NOL carryovers are reduced by 3-1/2 percentage points for each percentage point less than 40 percent (but not less than 20) of L shareholders' continuing interest. Thus, L's NOLs are reduced by 70 percent to $6 million. Assuming that section 269 is not applied, the NOL carryforwards that survive are sufficient to shelter P's income for six years. Under the present law rules, the entire $20 million NOL carryforward would survive because L shareholders received 20 percent of P's stock.

Similarly, if P corporation had purchased 80 percent of L's stock from L's shareholders, the 1976 Act amendments would provide the same result as in the merger example. Under present law rules, the entire $20 million NOL carryforward would survive and shelter P's income for a longer period (up to 15 years), provided that P maintains the bread factory business.

To address the concerns described above, the committee adopted the following approach: After a substantial ownership change, rather than reducing the NOL carryforward itself, the earnings against which an NOL carryforward can be deducted are limited. This general approach adopted by the committee has received wide acceptance among tax scholars and practitioners: This "limitation on earnings" approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against another taxpayer's income.

The limitation on earnings approach is intended to approximate the results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. This treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the corporation's NOL carryforward. Presumably, except in the case of tax-motivated partnership agreements, the loss corporation's share of the partnership's income would be limited to earnings generated by the assets contributed by the loss corporation.

For purposes of determining the income attributable to a loss corporation's assets, the bill prescribes an objective rate of return on the value of the corporation's equity. The committee was informed of the arguments made in favor of computing the prescribed rate of return by reference to the gross value of a loss corporation's assets, without regard to outstanding debt. The committee concluded that it would be inappropriate to permit the use of NOL carryforwards to shelter earnings that are used (or would be used in the absence of an acquisition) to service a loss corporation's debt. Because interest paid on indebtedness is deductible in its own right (thereby deferring the use of a corresponding amount of

NOLs), the effect of taking a loss corporation's gross value into account would be used had there been no change in ownership. Further, there is a fundamental difference between debt capitalization and equity capitalization: true debt represents a claim against a loss corporation's assets.

Annual limitation

In general, the annual limitation on the use of pre-acquisition NOL carryforwards is the product of the prescribed rate and the value of the loss corporation's equity immediately *before* a proscribed ownership change. In the case of an ownership change effected by a redemption, which results in a contraction of the loss corporation's assets, the committee concluded that it would be more appropriate to refer to the value of the loss corporation's assets immediately *after* the ownership change.

The committee selected the average yield for long-term marketable obligations of the U.S. government, adjusted to take account of tax exemption for interest, as the measure of a loss corporation's expected return on its assets. The committee chose the tax-exempt rate because it was concerned that if a taxable rate were used, the purchasers of a loss corporation would benefit from the grant of a rate on the portion of the loss corporation's equity value attributable to the NOL carryforward, thereby accelerating the use of pre-acquisition NOLs.

Example.—L corporation has assets with a value of $540 and an NOL carryforward of $2,000. L's assets generate a pre-tax return of 20-percent a year, or $108. Assume all of L's stock is sold for $1,000, which amount is assumed to be equal to the value of L's equity. If a pre-tax rate of return were used, NOL deductions of $200 per year would be allowed—more than L could have used had no change in ownership occurred or capital been infused. If an after-tax rate of return is used (assuming a 46-percent tax rate), NOL deductions of $108 (10.8 percent of $1,000) would be allowed in each post-acquisition year—exactly what L could have used under the stated assumptions.

The committee recognizes that the rate prescribed by the bill is higher than the average rate at which loss corporations actually absorb NOL carryforwards. Indeed, many loss corporations continue to experience NOLs, thereby increasing—rather than absorbing—NOL carryforwards. On the other hand, the adoption of the average absorption rate may be too restrictive for loss corporations that outperform the average. Therefore, it would be inappropriate to set a rate at the lowest rate that is theoretically justified. The committee concluded that the use of the long-term rate for Federal obligations, converted to a tax-exempt rate, was justified as the maximum risk-free rate of return a loss corporation could obtain in the absence of a change in ownership.

Anti-abuse rules

The committee realized that the mechanical rules described above could present unintended tax-planning opportunities and might foster certain transactions that many would perceive to be violative of the committee's intent. Therefore, the committee adopt-

ed various rules that are intended to prevent taxpayers from circumventing the special limitations or otherwise trafficking in loss corporations by (1) reducing a loss corporation's assets to cash or other passive assets and then selling off a corporate shell consisting of only NOLs and cash or other passive assets, or (2) making pre-acquisition infusions of assets to inflate artificially a loss corporation's value (and thereby accelerate the use of NOL carryforwards). In addition, the committee's bill retains the present law rules that are intended to limit tax-motivated acquisitions of loss corporations (e.g., section 269, relating to acquisitions to evade or avoid taxes, and the SRLY and CRCO rules).

The committee also was made aware of transactions in which an acquisition group desiring to acquire a profitable business through a leveraged buyout has entered into a partnership or other arrangement with another taxpayer with NOL carryforwards. For example, where a partnership is used as a vehicle, the partnership purchases the business, largely with borrowed funds. During the period in which it is using its available cash flow to repay the acquisition indebtedness, the partnership allocates a large portion of its income to the NOL partner, creating an excess capital account for that partner. After the acquisition indebtedness is retired, the partnership's income is allocated largely to the acquisition group, and the NOL partner receives prearranged distributions of cash to reduce the NOL partner's excess capital account. Typically, the NOL partner is not paid a market rate of interest on its excess capital account. As a result, the present value of its right to be repaid that amount is equal to or somewhat less than the taxes saved by the acquisition group as a result of the allocation to the NOL partner of the partnership's income during the period in which the acquisition indebtedness was being paid off. Thus, in essence, the acquisition group has purchased the NOL partner's NOLs for deferred payments.

The committee believes that the sale of NOLs in the manner described above is inconsistent with the limits placed on the use of NOLs by section 382 of the Code and therefore is improper. The committee believes the partnership allocations involved in certain of such transactions do not have substantial economic effect under section 704(b), and the Treasury Department has authority to deal with such transactions through regulations.

Technical problems

The committee's bill addresses the technical problems of present law by (1) coordinating the rules for taxable purchases with the rules for tax-free transactions, (2) expanding the scope of the rules to cover economically similar transactions that effect ownership changes (such as capital contributions, section 351 exchanges, and B reorganizations), (3) refining the definition of the term "stock," and (4) applying the special limitations to built-in losses.

Discontinuities

Because the current threshold for purchases is 50 percent, but the threshold for reorganizations is 20 percent, present law presents the possibility that economically similar transactions will receive disparate tax treatment. Further, the special limitations

apply after a purchase only if a pre-acquisition trade or business is discontinued, while the reorganization rule looks solely to changes in ownership. Finally, if the purchase rule applies, all NOL carryforwards are disallowed. In contrast, the rule for reorganizations merely reduces NOL carryforwards in proportion to the ownership change.

Continuity-of-business enterprise

The requirement that a loss corporation continue substantially the same business after a purchase presents potentially difficult definitional issues. Specifically, taxpayers and the courts are required to determine at what point a change in merchandise, location, size, or the use of assets should be treated as a change in the loss corporation's business. It is also difficult to identify a particular business where assets and activities are constantly combined, separated, or rearranged. Further, there is a concern that the present law requirement may induce taxpayers to continue uneconomic businesses.

The committee's bill eliminates the existing business-continuation rule; however, the continuity-of-business-enterprise rule applicable to tax-free reorganizations is extended to all other transactions that trigger the special limitations. The expansion of the scope of the continuity-of-business-enterprise requirement reflects the committee's view that the ongoing business enterprise (or the use of a portion of the historic assets) is an essential element of a corporation's identity. Therefore, the bill disallows NOL carryforwards entirely if this requirement is not satisfied for a two-year period.

Participating stock

In addition, the bill addresses the treatment of transactions in which the beneficial ownership of a NOL carryforward does not follow stock ownership. This problem is illustrated by the case of *Maxwell Hardware Co.*, in which a loss corporation's old shareholders retained common stock representing more than 50 percent of the corporation's value, but new shareholders received specially tailored preferred stock that carried with it a 90-percent participation in the corporation's earnings attributable to income-producing assets contributed by the new shareholders.[21] To address the problem, the bill defines stock to exclude stock that does not participate in a corporation's growth to any significant extent. The application of this definition to the facts of *Maxwell Hardware* would result in the application of special limitations (because the loss corporation's shareholders would not be viewed as retaining a significant interest in "stock").

Built-in gains and losses

The committee concluded that built-in losses, particularly depreciation deductions resulting from built-in losses, should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards. If built-in losses were not sub-

[21] 343 F.2d 713 (9th Cir. 1965).

ject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then investing the proceeds in assets similar to the assets sold).

The committee's bill also provides relief for built-in gains. Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (*e.g.*, accelerated depreciation or installment sales reporting). Absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred. (Similarly, a partnership is required to allocate built-in gain or loss to the contributing partner.)

Although the special treatment of built-in gains and losses will generally require valuations of a loss corporation's assets, the bill limits the circumstances in which valuations will be required by providing a de minimis rule. The committee's bill also provides a simplifying presumption in the case of certain stock acquisitions where it is reasonable to equate the value of the consideration used to acquire the stock with the value of a corporation's assets.

Other technical gaps

The committee's bill also corrects the following defects in present law: (1) only NOL deductions from prior taxable years are limited; thus, NOLs incurred in the year of a substantial ownership change are unaffected, (2) the rule for purchases is inapplicable to ownership changes resulting from section 351 exchanges, capital contributions, the liquidation of a partner's interest in a partnership that owns stock in a loss corporation, and nontaxable acquisitions of interests in a partnership (*e.g.*, by contribution) that owns stock in a loss corporation, (3) the reorganization rule is inapplicable to B reorganizations, (4) the measurement of the continuing interest of a loss corporation's shareholders after a triangular reorganization enables taxpayers to circumvent the 20-percent-continuity-of-interest rule, and (5) taxpayers take the position that the reorganization rule does not apply to reverse mergers (where an acquiring corporation's subsidiary merges into a loss corporation and the loss corporation's shareholders receive stock of the acquiring corporation in the exchange).

Insolvent corporations

Finally, the committee reviewed the treatment of ownership changes of insolvent corporations. Under the general rule of the committee's bill, no carryforwards would survive the acquisition of an insolvent corporation because the corporation's equity value immediately before the acquisition would be zero. In such a case, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when

ownership shifted from the corporation's shareholders.[22] While the committee concluded that relief from a strict application of the general rule should be provided, as the creditors of an insolvent corporation frequently bear the losses reflected in a NOL carryforward, the committee discerned no tax policy reason that would justify a blanket exception from the special limitations. The former creditors of an insolvent loss corporation are as likely as any other new owners to attempt to accelerate the use of pre-acquisition NOLs. The committee was also concerned about the potential for abusive transactions if an exception made. For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. The committee also believes that allowing favorable tax treatment for creditors of insolvent corporations could divert lending away from sovlent corporations, including start-up corporations, that may contribute more to the productivity of the economy.

For these reasons, the committee's bill provides that the annual limitation after a G reorganization or a stock-for-debt exchange that occurs as part of a Title 11 or similar proceeding is computed by reference to the value of the loss corporation's equity immediately *after* the end of a bankruptcy proceeding (when ownership is formally shifted) (similar to the treatment of redemptions under the bill). In this manner, the use of NOL carryforwards after a G reorganization or qualified stock-for-debt exchange will be limited to the equity value that remains after the discharge of a loss corporation's debts, subject to the bill's anti-abuse rules relating to passive assets and capital contributions.

Transactions involving thrifts

In the case of financially troubled thrifts, typically, a profitable financial institution assumes the thrift's obligations, in exchange for payments from a regulatory body such as FSLIC, and the right to utilize the thrift's NOLs and assume the thrift's basis in its assets (which generally consist of mortgage loans with a book value substantially in excess of market value). Generally, no consideration is paid to the thrift's shareholders or depositors; rather, the consideration used to acquire control is paid to the thrift itself. Also, the thrift may receive financial assistance from a regulatory authority. After reviewing this state of affairs, the committee determined that no special rules should apply to acquisitions of thrift institutions.

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[22] *Cf. Helvering* v *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) ("When the equity owners are excluded and the old creditors become the stockholders..., it conforms to reality to date [the creditors'] equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority").

Explanation of Provisions

Overview

The bill alters the character of the special limitations on the use of NOL carryforwards. After a change in ownership of more than 50 percent of the value of stock in a loss corporation, however effected, the taxable income available for offset by pre-acquisition NOLs is limited to a prescribed rate times the value of the loss corporation's equity. In addition, NOLs are disallowed unless the loss corporation satisfies the continuity-of-business-enterprise rule that applies to tax-free reorganizations for the two-year period following an ownership change, regardless of the type of transaction that results in the change of control (*i.e.*, the continuity-of-business enterprise doctrine is made applicable to purchase transactions for NOL carryover purposes). The bill also expands the scope of the special limitations to include built-in losses and takes into account built-in gains. The bill includes other changes, of a more technical nature, including rules relating to the measurement of beneficial ownership. The bill applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Trigger events

Under the bill, special limitations apply after a "trigger." A "trigger" occurs if there is an "owner shift" of more than 50 percent or an "equity structure change" of more than 50 percent during a three-year testing period.

Determinations of the percentage of stock in a corporation held by any person are made on the basis of value. Under regulations to be prescribed by the Secretary, changes in proportionate ownership attributable solely to fluctuations in the relative fair market values of different classes or amounts of stock are not taken into account.

In determining whether a trigger has occurred, changes in the holdings of certain preferred stock are disregarded. Thus, all "stock" (other than stock described in section 1504(a)(4), relating to stock that is excluded in determining whether affiliated corporations are eligible to file consolidated tax returns) is taken into account. Under this standard, the stock to be disregarded is stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock.[23] Under this rule, preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be disregarded.

Owner shift

An "owner shift" is defined to include any change in the holdings of stock in a corporation, other than by an "equity structure

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[23] The committee intends that stock having the characteristics of the stock issued to the loss corporation shareholders in *Maxwell Hardware* v. *Commissioner*, 343 F. 2d 713 (9th Cir. 1965), would not qualify under this standard.

change" (defined below). Examples of transactions that effect owner shifts include the following:

(1) A purchase of stock in a loss corporation from an existing shareholder or from the corporation itself,

(2) A section 351 exchange (*i.e.*, a transfer of property to a loss corporation after which the transferor(s) owns 80 percent or more of the corporation's stock, or the transfer of stock in a loss corporation to another corporation in an exchange to which section 351 applies),

(3) A decrease in the total outstanding stock of a loss corporation (including changes effected by a redemption from other shareholders),

(4) An increase in the total outstanding stock of a loss corporation (including changes effected by the issuance of new stock or contributions to the capital of a loss corporation),

(5) The conversion of a mutual savings and loan association to a stock savings and loan association,

(6) The conversion of nonparticipating stock to participating stock, and

(7) Any combination of the foregoing.

An owner shift of more than 50 percent occurs if the percentage of a loss corporation's stock (determined by value) that is held by "five-percent shareholders" at the close of the three-year period preceding any owner shift (referred to as the testing period) has increased by more than 50 percentage points over the holdings by such shareholders at the beginning of the testing period. For purposes of this rule, the term "five-percent shareholder" is defined as any person holding five percent or more in value of the stock of a corporation at any time during the testing period. All less-than-five-percent shareholders are aggregated and treated as one five-percent shareholder.

Example 1.—The stock of L corporation is publicly traded; no shareholder holds more than five percent. During the three-year period ending on January 1, 1989, there are numerous trades involving L stock. No trigger event will occur so long as no person (or persons) becomes a five-percent shareholder *and* acquires more than 50 percent of the value of L's stock.

Example 2.—On January 1, 1987, L corporation is publicly traded; no shareholder holds more than five percent. On September 1, 1987, individuals A, B, and C, who were not previously shareholders of L and are unrelated to any such shareholders, each acquire one-third of the stock of L. Accordingly, A, B and C each become five-percent shareholders of L who, in the aggregate, have increased their holdings by over 50 percentage points from what they held at any point during the three years prior to September 1, 1987. Therefore, there has been a more than 50 percent owner shift.

Example 3.—On January 1, 1987, X owns all 1000 shares of corporation L. On June 15, 1987, he sells 300 of his L shares to A. On January 15, 1988, L issues 100 shares to each of B, C. and D. On December 15, 1988, L redeems more than 200 shares owned by X. Based on these facts, there is a more than 50-percent owner shift of L on December 15, 1988.

Example 4.—L corporation is closely held by four individuals. On January 1, 1987, there is a public offering of stock in L, as a result of which less-than-five-percent shareholders acquire stock representing 80% of the L stock that is outstanding. All of the holdings of the less-than-five-percent shareholders are aggregated for purposes of determining the magnitude of the owner shift. On these facts, the 80 percentage points representing the increase in the holdings of less-than-five-percent shareholders are taken into account as if there was an 80-percentage-point increase in the holdings of a single five-percent shareholder. Thus, a more than 50-percent owner shift has occurred.

Example 5.—On January 1, 1987, L is wholly-owned by X. On January 1, 1988, X sells 50 percent of his stock to 1000 shareholders unrelated to him. On January 1, 1989, X sells his remaining 50-percent interest to an additional 1000 shareholders unrelated to him. Based on these facts, as of January 1, 1988, there has not been a more than 50 percent owner shift. On January 1, 1989, there is a more than 50 percent owner shift because as of that date the less than five-percent shareholders (who are treated as a single five-percent shareholder) have increased by more than 50 percentage points their stock holdings in L.

Equity structure change

An equity structure change is defined to include any tax-free reorganization other than a divisive reorganization. An equity structure change of more than 50 percent occurs if the continuing interest of a loss corporation's shareholders (identified immediately before the reorganization) is less than 50 percent after the reorganization. For purposes of this definition, the continuing interest of a loss corporation's shareholders is generally measured by reference to the percentage of the value of the stock in the acquiring corporation owned (immediately after the reorganization) as the result of owning stock in the loss corporation. If there has been an increase in the holdings of the loss corporation's five-percent shareholders during the three-year period ending immediately before an equity structure change, then the continuing interest percentage determined under the general rule is adjusted to take account of such increase.

Example 6.—On January 1, 1988, L corporation is merged (in a tax-free transaction) into P corporation, with P surviving. Both L and P are publicly traded corporations with no shareholder owning as much as five percent of either corporation or of the surviving entity. In the merger, the former shareholders of L receive 30 percent of the stock of P, and the remaining stock of P is owned by P shareholders unrelated to the former shareholders of L. There has been an equity structure change of L because the continuing interest of former L shareholders in the surviving corporation is less than 50 percent. If, however, the former shareholders of L received 70 percent of the stock of P in the merger, there would not be a more than 50 percent equity structure change of L.

Example 7.—On January 1, 1989, I (an individual) purchases 40 percent of the stock of L. On July 1, 1989, L is merged into P—which is wholly owned by I—in a tax-free reorganization. In exchange for their stock in L, the L shareholders (immediately before

the merger) receive stock with a value representing 60 percent of the P stock that is outstanding immediately after the merger. No other transactions occurred with respect to stock in L during the three-year period preceeding the reorganization.

Under the general rule for testing the continuing interest of a loss corporation's shareholders, the continuing interest of L's shareholders is 60 percent. The 60-percent figure is subject to adjustment, however, because there was an increase in the holdings of a five-percent shareholder during the testing period. As adjusted, the continuing interest percentage is 36 percent (60 percent continuing interest times 60 percent (100-40 percentage point increase in I's holdings in L)). Thus, the merger is treated as an equity structure change of more than 50 percent.

Attribution of stock ownership

In determining ownership of stock for purposes of determining whether a trigger has occurred, the constructive ownership rules of section 318 are applied, except (1) the rules for attributing ownership among family members are applied by assuming that family status as of the close of a testing period was the same as that at the beginning of a testing period, (2) the rules for attributing ownership among corporations and their shareholders are applied without regard to the condition that a shareholder own 50 percent or more of a corporation's stock, (3) a corporation is considered as owning stock (other than stock in such corporation) owned by or for any shareholder of the corporation, in the proportion that the value of the stock owned by such shareholder in the corporation bears to the value of all stock in the corporation, and (4) to the extent provided in regulations, the rules relating to the ownership of stock subject to an option will not apply. Further, stock in any corporation that is treated as owned by such corporation by reason of the rules relating to the attribution of ownership from partnerships, estates, trusts, and corporations, is not treated as outstanding stock. By application of the constructive ownership rules, the acquisition of one corporation by another corporation under common control does not constitute a trigger.

Example 8.—Corporation B owns 100 percent of the stock of corporation L. Corporation C owns 100 percent of the stock of corporation P. Corporation A owns 80 percent of each of B and C. On January 1, 1988, L merges into P, with P surviving, and B is completely cashed out. The transaction is not an ownership change of L. Before the merger, B owned 100 percent of L. After the merger, B indirectly owns 64 percent of L. (B is treated as owning 80 percent of the stock owned by A; A is treated as owning 80 percent of P; therefore, B indirectly owns 64 percent of P.) Therefore, the total value of stock of P treated as owned by the former shareholders of L is not more than 50 percentage points less than the total value of the stock of L owned by the former L shareholders.

Waiver of back attribution in certain cases.—Under regulations prescribed by the Secretary, attribution to partnerships, trusts, and estates from partners, beneficiaries, and shareholders will not apply to the extent that such attribution is not necessary to carry out the purpose of the special limitations.

Prevention of double counting.—Under regulations to be prescribed by the Secretary, the constructive ownership rules will be applied in a manner that will result in only one person being treated as owning any share of stock. Under this rule, stock is to be attributed to the person whose ownership would result in the largest percentage increase or the smallest continuing interest, as the case may be, in determining whether a trigger has occurred.

Stock acquired by reason of death.—If the basis of stock in the hands of a person is determined under section 1014 (relating to property acquired from a decedent), or stock is received in satisfaction of a pecuniary bequest, then the holder is treated as having owned the stock during the period the stock was held by the decedent. This rule applies only with respect to a decedent who is a member of the holder's family (within the meaning of section 318(a)(1)(A)).

Three-year testing period

In general, the relevant testing period is the three-year period preceding an owner shift or an equity structure change. A shorter period is applicable where there has been a prior trigger. In such a case, the testing period for determining whether a subsequent trigger has occurred with respect to such carryforward does not begin before the prior trigger.

Effect of trigger

Continuity-of-business enterprise

After a trigger, a loss corporation's NOL carryforwards (including certain built-in losses, discussed below) are subject to complete disallowance unless the continuity-of-business-enterprise requirement is satisfied during the two-year period beginning on the trigger day. This continuity-of-business-enterprise requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368. In general, this continuity-of-business enterprise doctrine requires the loss corporation (or the surviving corporation) either to continue the loss corporation's historic business or use a significant portion of the loss corporation's assets in a business. In contrast to the existing business-continuation rule of section 382(a), changes in the location of a loss corporation's business or the loss corporation's key employees, or similar changes, would not constitute a failure to satisfy the continuity-of-business enterprise requirement. Similarly, the requirement may be satisfied even though the loss corporation discontinues more than a minor portion of its historic business.

Annual limitation

Assuming that the continuity-of-business-enterprise requirement is satisfied, for any taxable year ending after the trigger day, the amount of a loss corporation's taxable income that can be offset by a "pre-trigger loss" (defined below) cannot exceed the trigger amount for such year. For purposes of this rule, a corporation's taxable income is computed with the modifications set forth in section 172(d). The "trigger amount" for any taxable year is an amount equal to the "trigger value" (defined below) of the loss cor-

poration multiplied by the "long-term tax-exempt rate" (also defined below) in effect on the trigger day. If the trigger amount for a taxable year exceeds the taxable income for the year, the trigger amount for the next taxable year is increased by the amount of the excess. The trigger amount for a taxable year is also increased by certain "built-in gains" (discussed below).

Special rule for post-trigger year that includes the trigger day.—For the taxable year in which a trigger occurs, the annual limitation does not apply to the portion of a loss corporation's income that is allocable (determined on a daily pro rata basis) to the period in such year before the trigger day. For the taxable year in which a trigger occurs, the trigger amount is equal to an amount that bears the same ratio to the trigger amount (determined without regard to this rule) as the number of days in such year on or after the trigger day bears to the total number of days in such year.

Trigger value

Generally, the trigger value of a loss corporation is the fair market value of the corporation's equity immediately before the trigger. The price at which stock in the loss corporation changes hands would be evidence, but not conclusive evidence, of the value of the corporation's stock. For example, assume that an acquiring corporation purchased 40 percent of stock in a loss corporation over a 12-month period. Six months after the end of the initial acquisition period, the acquiring corporation purchases an additional 20-percent of the loss corporation's stock at a price that reflects a premium over the stock's fair market value; the premium is paid because the 20-percent block carries with it effective control of the loss corporation. On these facts, it would be inappropriate to include the premium paid for the 20-percent interest in the measure of the corporation's equity value.

Definition of "equity."—The term "equity" means (1) stock, (2) warrants or other options (issued by the corporation) to acquire an interest in the equity of a corporation, (3) the conversion feature of convertible debt, and (4) any other interest in the equity of the corporation.

Special rule for redemptions.—If the last component event of an owner shift is a redemption, the trigger value is the fair market value of the loss corporation's equity immediately *after* the trigger.

Special rule for bankruptcy reorganizations.—If the trigger occurs as a result of a G reorganization or a stock-for-debt exchange that occurs as part of a Title 11 or similar proceeding, the trigger value is the fair market value of the loss corporation's equity immediately *after* the trigger.

Long-term tax-exempt rate

The "long-term tax-exempt rate" is the rate that is (1) determined by the Secretary under section 1274 (relating to debt instruments issued for property), based on the average yield for long-term marketable obligations of the U.S. Government, as adjusted pursuant to section 1288 (relating to original issue discount on tax-exempt bonds) to take into account tax exemption for interest on the obligation, and (2) in effect on the trigger day. The committee anticipates that the Treasury Department will publish the long-

term tax-exempt rate with the same frequency and applicability as the applicable Federal rates under section 1274.

Example 9.—Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1986, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L's equity was $500,000 and the long-term tax-exempt rate was 10 percent. Finally, L incurred a net operating loss during 1986 of $100,000, and L had no built-in gains or losses.

Under these facts, assuming the continuity-of-business enterprise requirement is satisfied, the taxable income of L after July 1, 1986, that could be offset by L's losses incurred prior to July 1, 1986, would generally be limited. In particular, for all taxable years after 1986, the pre-trigger losses of L could be used to offset no more than $50,000 of L's taxable income each year ($25,000 (1/2 x $50,000 annual limitation) in L's 1986 taxable year). The "pre-trigger losses" of L would constitute the $1 million of NOL carryforwards plus one-half of the 1986 net operating loss, or a total of $1,050,00. If, in taxable year 1987, L had only $30,000 of taxable income to be offset by L's losses, then the amount of L's 1988 taxable income that could be offset by pre-trigger losses would be limited to $95,000 ($50,000 annual limit plus $45,000 carryover).

If L had income of $100,000 in 1986, instead of a net operating loss, L's 1986 taxable income that could be offset by pre-trigger losses would be limited to $75,000 (1/2 x $50,000 plus 1/2 x $100,000 1986 income).

Reduction in trigger value for capital contributions made during testing period

Generally, the trigger value is reduced by an amount equal to the aggregate capital contributions received by the loss corporation during the three-year testing period. For purposes of this rule, the term "capital contribution" generally includes any amount received by a corporation for stock in the corporation or as a capital contribution. The committee intends the term capital contribution to be interpreted broadly to encompass any direct or indirect infusion of capital into a loss corporation. An exception is provided for amounts received by a corporation pursuant to an employee stock option plan or a dividend reinvestment plan that meets standards prescribed by the Secretary. In addition, the Secretary is authorized to issue regulations that set forth a de minimis exception to the general definition of a capital contribution. The committee expects that these regulations will allow small contributions made in the ordinary course of the loss corporation's business (i.e. to fund operating expenses).

Reduction in trigger value for corporations having substantial nonbusiness assets

If at least one-third of the fair market value of a corporation's assets consists of nonbusiness assets, then the trigger value is reduced by the excess of the value of the nonbusiness assets over the portion of the corporation's indebtedness attributable to such assets. For purposes of this rule, the term "nonbusiness assets" is

defined as cash, marketable stock or securities, and any other asset not held for active use in a trade or business or disposed of (other than in the ordinary course of the corporation's business) pursuant to a plan or arrangement in existence before the trigger day. The amount of a corporation's indebtedness attributable to nonbusiness assets is the amount that bears the same ratio to such indebtedness as the value of the nonbusiness assets bears to the value of all of the corporation's assets.

Stock or securities in a subsidiary corporation are excluded from the definition of marketable stock or securities. Instead, the parent corporation is deemed to own its ratable share of the subsidiary's assets. A corporation is treated as holding stock in a subsidiary if the corporation owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of all classes of stock.

Losses subject to limitation

The term "pre-trigger loss" includes (1) for the taxable year in which a trigger occurs, the portion of the loss corporation's NOL that is allocable (determined on a daily pro rata basis) to the period in such year before the trigger day, (2) NOL carryforwards that arose in a taxable year preceding the taxable year of the trigger, and (3) certain recognized built-in losses and deductions (described below).

For any taxable year in which a corporation has income that, under section 172, may be offset by both a pre-trigger loss (i.e., an NOL subject to limitation) and an NOL that is not subject to limitation, taxable income is treated as having been first offset by the pre-trigger loss. This rule minimizes the NOLs that are subject to the special limitations.

Built-in losses

If a loss corporation has a net unrealized built-in loss, the recognized built-in loss for any taxable year ending within the ten-year period following the trigger (the "recognition period") is treated as a pre-trigger loss.

Net unrealized built-in losses.—The term "net unrealized built-in loss" is defined as the amount by which the aggregate adjusted bases of a corporation's assets exceeds the value of the corporation's assets as of the trigger day. In the case of an 80-percent owner shift or equity structure change that occurs in a single transaction (or a series of related transactions within any 12-month period), the value of the loss corporation's assets can not exceed the value of the consideration used to acquire stock in the corporation (grossed-up where less than 100 percent is acquired and adjusted for the corporation's liabilities and other relevant items). Under a de minimis exception, the special rule for built-in losses is not applied if the amount of a net unrealized built-in loss does not exceed 15 percent of the value of a corporation's assets. For purposes of the de minimis exception, the value of a corporation's assets is determined by excluding any (1) cash, (2) cash items (as defined for purposes of section 368(a)(2)(F)(iv)), or (3) marketable securities that have not declined or appreciated substantially in value (as defined in regulations).

Example 10.—L, a corporation holds two assets: asset X, with a basis of 150 and a value of 50 (a built-in loss asset), and asset Y, with a basis of zero and a value of 50 (a built-in gain asset). L has a net unrealized built-in loss of 50 (the excess of the aggregate bases of 150 over the aggregate value of 100).

If the last component of a trigger is a redemption, the determinations described in the preceding paragraph are made as of the time immediately after the trigger.

Recognized built-in losses.—The term "recognized built-in loss" is defined as (1) any loss that is recognized on the disposition of an asset during the recognition period, to the extent of the excess of the asset's adjusted basis over its value as of the trigger day, and (2) for any taxable year, any amount allowable for depreciation, amortization, or depletion attributable to the excess of an asset's adjusted basis over its value as of the trigger day. The recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

Accrued deductions.—The Secretary is authorized to issue regulations under which amounts that accrue before the trigger day but are allowable as a deduction on or after such day (e.g., deductions deferred by section 267 or section 465) will be treated as built-in losses.

Built-in gains

If a loss corporation has a net unrealized built-in gain, the trigger amount for any taxable year ending within the recognition period is increased by the recognized built-in gain for the taxable year.

Net unrealized built-in gains.—The term "net unrealized built-in gain" is defined as the amount by which the value of a corporation's assets (subject to the special rule described above in the case of 80-percent changes) exceeds the aggregate bases of such assets as of the trigger day. Under a de minimis exception, the special rule for built-in gains is not applied if the amount of a net unrealized built-in gain does not exceed 15 percent of the bases of a corporation's assets. For purposes of the de minimis exception, the aggregate basis of a corporation's assets is determined by excluding any (1) cash, (2) cash items, or (3) marketable securities, (all as defined for purposes of the de minimis exception applicable to built-in losses).

If the last component of a trigger is a redemption, the determinations described in the preceding paragraph are made as of the time immediately after the trigger.

Recognized built-in gains.—The term "recognized built-in gain" is defined as any gain recognized on the disposition of an asset during the recognition period, to the extent of the excess of the asset's value over its adjusted basis as of the trigger day. The recognized built-in gain for a taxable year cannot exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

Effect of certain capital contributions

For purposes of the de minimis exceptions applicable to built-in gains and losses, certain capital contributions received by a corporation during the three-year testing period are excluded from the value of the corporation's assets. The capital contributions subject to this rule are the same amounts that are excluded from a corporation's trigger value (discussed above). Further, to the extent capital contributions of property are identifiable as of the trigger, they are not taken into account for any purpose under the special rules for built-in gains and losses (e.g., the rule for netting built-in gains and losses).

General regulatory authority

The Secretary is authorized to prescribe such regulations as may be necessary or appropriate, including (but not limited to) regulations (1) providing rules for the treatment of successive triggers, (2) treating warrants and obligations convertible to stock as stock, and (3) treating options as having been exercised.

Carryforwards other than NOLs

The bill also amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital losses. Under regulations to be prescribed by the Secretary, capital loss carryforwards and the deduction equivalent of credit carryforwards will be limited to an amount determined on the basis of the tax liability that is attributable to so much of the taxable income as does not exceed the trigger amount for the taxable year, with the same ordering rules that apply under present law.

Tax-motivated transactions

Nothing in the bill affects the continuing application of section 269, relating to acquisitions made to evade or avoid taxes. Similarly, the SRLY and CRCO rules under the regulations governing the filing of consolidated returns continue to apply.

Libson Shops

The committee intends that the *Libson Shops* doctrine will have no application to transactions subject to the provisions of the bill.

1976 Act Amendments

The bill generally repeals the amendments made by the Tax Reform Act of 1976.

Effective Dates

The provisions of the bill apply to more than 50-percent owner shifts that occur on or after January 1, 1986. In the case of equity structure changes, the new rules take effect for reorganizations pursuant to plans adopted on or after January 1, 1986. A reorganization plan will be considered adopted on the date that the boards of directors of all parties to the reorganization adopt the plans or recommends adoption to the shareholders, or on the date the shareholders approve, whichever is earlier. The earliest testing period

under the bill begins on October 28, 1985 (the date of committee action).

If a purchase or reorganization that occurs after December 31, 1985 is not affected by the bill (because, for example, an insufficient ownership change occured after October 28, 1985), the existing provisions of section 382 will remain applicable to the transaction. The bill contemplates that the Secretary will prescribe the long-term tax-exempt rate (pursuant to existing authority in section 1288) before January 1, 1986.

Special transitional rules are provided, under which present law continues to apply to ownership changes after January 1, 1986, if:

(1) In the case of a section 368(a)(1)(G) reorganization or a section 368(a)(3) stock-for-debt exchange, (a) the ownership change occurs pursuant to a plan of reorganization that was filed with a court on or before September 25, 1985, or (b) the reorganization occurs before January 1, 1989, but only with respect to the amount of such claims held by persons who were creditors as of September 25, 1985, or who became creditors after that date with respect to claims under contracts that were binding on September 25, 1985, and who receive stock in the reorganization;[24]

(2) a mutual savings and loan association that holds a Federal charter dated March 22, 1985, is converted to a stock savings and loan association, pursuant to the rules and regulations of the Federal Home Loan Bank Board;

(3) the stock of a corporation is acquired pursuant to a plan of divestiture, which identified the corporation and its assets, and was agreed to by the Board of Directors of the corporation's parent corporation on May 17, 1985;

(4) a merger occurs pursuant to a merger agreement that was approved by both parties to such agreement and is entered into on or before September 24, 1985, if an application for approval of such merger was filed with the Federal Home Loan Bank Board on October 4, 1985; or

(5) a reorganization occurs involving a party to a reorganization of a group of corporations engaged in enhanced oil recovery operations in California, merged in furtherance of a plan of reorganization adopted by board of directors vote on September 24, 1985, and a Delaware corporation whose principal oil -and gas-producing fields are located in California.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $16 million in 1986, $43 million in 1987, $73 million in 1988, $106 million in 1989, and $136 million in 1990.

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[24] In the latter case, present law will apply if persons who were creditors as of September 25, 1985, obtain control by virtue of the claims held on September 25, 1985, in the G reorganization or a transaction described in section 368(a)(3); transferees of such persons will not qualify for this treatment, nor will present law rules apply to subsequent ownership changes that constitute a trigger.

G. Recognition of Gain and Loss on Liquidating Sales and Distributions of Property (Repeal of the *General Utilities* Doctrine) (Sec. 331 of the bill and secs. 336, 337, 338, and 1362 of the Code)

Present Law

Overview

As a general rule, corporate earnings from sales of appreciated property are taxed twice, first to the corporation when the sale occurs, and again to the shareholders when the net proceeds are distributed as dividends. At the corporate level, the income is taxed at ordinary rates if it results from the sale of inventory or other ordinary income assets, or at capital gains rates if it results from the sale of a capital asset held for more than six months. With certain exceptions, shareholders are taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to this two-level taxation of corporate earnings is the so-called *General Utilities* rule.[1] The *General Utilities* rule permits nonrecognition of gain by corporations on certain distributions of appreciated property[2] to their shareholders and on certain liquidating sales of property. Thus, its effect is to allow appreciation in property accruing during the period it was held by a corporation to escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtains a stepped-up, fair market value basis under other provisions of the Code, with associated additional depreciation, depletion, or amortization deductions. Accordingly, the "price" of a step up in the basis of property subject to the *General Utilities* rule is typically a single capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

Although the case involved a dividend distribution of appreciated property by an ongoing business, the term "*General Utilities* rule" is often used (and will be used herein) in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule is reflected in section 311, 336, and 337 of the Code. Section 311 governs the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governs the treatment of liquidating distributions in

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[1] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

[2] Taxable gain may result on disposition of property even if the property's economic value remains constant (or decreases) over the taxpayer's holding period, due to tax depreciation and other downward adjustments to basis. The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted (and not necessarily its original) basis in the hands of the transferor corporation.

kind. Section 337 provides nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation.

Numerous limitations on the *General Utilities* rule, both statutory and judicial, have developed over the years. Some directly limit the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, do so indirectly.

Case law and statutory background

Genesis of the General Utilities rule

The precise meaning of *General Utilities* has been a matter of considerable debate since the decision was rendered in 1935. The essential facts were as follows. General Utilities had purchased 50 percent of the stock of Islands Edison Co. in 1927 for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' shares in Islands Edison, which apparently had a fair market value at that time of more than $1 million. Seeking to avoid the large corporate-level tax that would be imposed if it sold the stock itself, General Utilities offered to distribute the Islands Edison stock to its shareholders with the understanding that they would then sell the stock to the buyer. The company's officers and the buyer negotiated the terms of the sale but did not sign a contract. The shareholders of General Utilities had no binding commitment upon receipt of the Islands Edison shares to sell them to the buyer on these terms.

General Utilities declared a dividend in an amount equal to the value of the Islands Edison stock, payable in shares of that stock. The corporation distributed the Islands Edison shares and, four days later, the shareholders sold the shares to the buyer on the terms previously negotiated by the company's officers.

The Internal Revenue Service took the position that the distribution of the Islands Edison shares was a taxable transaction to General Utilities. Before the Supreme Court, the Commissioner argued that the company had created an indebtedness to its shareholders in declaring a dividend, and that the discharge of this indebtedness using appreciated property produced taxable income to the company under the holding in *Kirby Lumber Co.* v. *United States*.[3] Alternatively, he argued, the sale of the Islands Edison stock was in reality made by General Utilities rather than by its shareholders following distribution of the stock. Finally, the Commissioner contended that a distribution of appreciated property by a corporation in and of itself constitutes a realization event. All dividends are distributed in satisfaction of the corporation's general obligation to pay out earnings to shareholders, he argued, and the satisfaction of that obligation with appreciated property causes a realization of the gain.

The Supreme Court held that the distribution did not give rise to taxable income under a discharge of indebtedness rationale. The Court did not directly address the Commissioner's third argument, that the company realized income simply by distributing appreciated property as a dividend. There is disagreement over whether the

[3] 284 U.S. 1 (1931).

Court rejected this argument on substantive grounds or merely on the ground it was not timely made. Despite the ambiguity of the Supreme Court's decision, however, subsequent cases interpreted the decision as rejecting the Commissioner's third argument and as holding that no gain is realized on corporate distributions of appreciated property to its shareholders.

Five years after the decision in *General Utilities*, in a case in which the corporation played a substantial role in the sale of distributed property by its shareholders, the Commissioner successfully advanced the imputed sale argument the Court had rejected earlier on procedural grounds. In *Commissioner* v. *Court Holding Co.*,[4] the Court upheld the Commissioner's determination that in substance the corporation rather than the shareholders had executed the sale and, accordingly, must recognize gain.

In *United States* v. *Cumberland Public Service Co.*,[5] the Supreme Court reached a contrary result where the facts showed the shareholders had in fact negotiated a sale on their own behalf. The Court stated that Congress had imposed no tax on liquidating distributions in kind or on dissolution, and that a corporation could liquidate without subjecting itself to corporate gains tax notwithstanding the primary motive is to avoid the corporate tax.[6]

In its 1954 revision of the Internal Revenue Code, Congress reviewed *General Utilities* and its progeny and decided to address the corporate-level consequences of distributions statutorily. It essentially codified the result in *General Utilities* by enacting section 311(a), providing that no gain or loss is recognized to a corporation on a nonliquidating distribution of property with respect to its stock. Congress also enacted section 336, which in its original form provided for nonrecognition of gain or loss to a corporation on distributions of property in partial or complete liquidation. As discussed below, section 336 no longer applies to distributions in partial liquidation, though in certain limited circumstances a distribution in partial liquidation may still qualify for nonrecognition at the corporate level.

Finally, Congress in the 1954 Act provided that a corporation does not recognize gain or loss on a sale of property if it adopts a plan of complete liquidation and distributes all of its assets to its shareholders within twelve months of the date of adoption of the plan (sec. 337). Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Public Service Co.*, between a sale of assets followed by liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, was in large part eliminated. Regulations subsequently issued under section 311 acknowledged that a distribution in redemption of stock constituted a "distribution with respect to ... stock" within the meaning of the statute.[7] The 1954 Code in its original form, therefore, generally exempted all forms of nonliquidating as well as liquidating distributions to shareholders from the corporate-level tax.

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[4] 324 U.S. 331 (1945).
[5] 338 U.S. 451 (1950).
[6] *Id.* at 454-455.
[7] Treas. Reg. sec. 1.311-1(a).

Nonliquidating distributions: section 311

Congress has enacted a number of statutory exceptions to the *General Utilities* rule. Under present law, the general rule for nonliquidating distributions reverses the presumption under *General Utilities* and holds that a corporation recognizes gain (but not loss) on a distribution of property as a dividend or in redemption of stock.[8] The distributing corporation is treated as if it sold the property for its fair market value on the date of the distribution. A number of exceptions to the general rule are provided. First, no gain is generally recognized to the distributing corporation with respect to distributions in partial liquidation made with respect to "qualified stock." Qualified stock is defined as stock held by noncorporate shareholders who at all times during the five-year period prior to the distribution (or the period the corporation has been in existence, if shorter) owned 10 percent or more in value of the distributing corporation's outstanding stock.[9]

Second, an exception from the general gain recognition rule is provided for a distribution with respect to qualified stock that constitutes a "qualified dividend." A "qualified dividend" for this purpose is a dividend of property (other than inventory or receivables) used in the active conduct of certain "qualified businesses."[10] A "qualified business" is any trade or business that has been actively conducted for the five-year period ending on the date of the distribution and was not acquired in a transaction in which gain or loss was recognized in whole or in part during such period.[11] Thus, nonrecognition under this exception does not apply to distributions from holding companies or consisting of ordinary income property, and is limited to distributions to certain long-term, 10-percent shareholders other than corporations.

Third, an exception is provided for distributions with respect to qualified stock of stock or obligations in a subsidiary if substantially all of the assets of the subsidiary consist of the assets of one or more qualified businesses, no substantial part of the subsidiary's nonbusiness assets were acquired in a section 351 transaction or as a capital contribution from the distributing corporation within the five-year period ending on the date of the distribution, and more than 50 percent in value of the stock of the subsidiary is distributed with respect to qualified stock.[12]

Finally, exceptions are provided for redemptions to pay death taxes, certain distributions to private foundations, and distributions by certain regulated investment companies in redemption of stock upon the demand of a shareholder.[13]

Section 311 also provides under separate rules that a corporation recognizes gain on the distribution of encumbered property to the extent the liabilities assumed or to which the property is subject

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[8] The statute literally applies to "distribution[s] to which subpart A [of subchapter C, part I] applies . . . ." (sec. 311(d)(1)(A)).

[9] See secs. 311(d)(2)(A); 302(b)(4), (e). The Treasury Department has regulatory authority to prevent taxpayers not eligible for this special partial liquidation treatment from obtaining these benefits through the use of section 355, 351, 337, or other provisions of the Code or the regulations. Sec. 346(b).

[10] Sec. 311(e)(3).

[11] Sec. 311(e)(2)(B)(i).

[12] Sec. 311(d)(2)(B).

[13] Sec. 311(d)(2)(C), (D), (E).

exceed the distributing corporation's adjusted basis;[14] on the distribution of LIFO inventory, to the extent the basis of the inventory determined under a FIFO method exceeds its LIFO value;[15] and on the distribution of an installment obligation, to the extent of the excess of the face value of the obligation over the distributing corporation's adjusted basis in the obligation.[16]

Liquidating distributions and sales: sections 336 and 337

The rules regarding nonrecognition of gain on distributions in liquidation of a corporation are less restrictive than those applicable to nonliquidating distributions. Section 336 generally provides for nonrecognition of gain or loss by a corporation on the distribution of property in complete liquidation of the corporation. Gain must be recognized, however, on a distribution of an installment obligation, unless acquired in a liquidating sale that would be tax-free under section 337 or distributed by a controlled subsidiary in a section 332 liquidation where the parent takes a carryover basis under section 334(b)(1).[17] Section 336 also requires recognition of the LIFO recapture amount in liquidating distributions.

Section 337 provides that if a corporation adopts a plan of complete liquidation and within twelve months distributes all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period generally is not recognized. Section 337 does not apply, and recognition is required, on sales of inventory (other than inventory sold in bulk), stock in trade, and property held primarily for sale to customers in the ordinary course of business. If the corporation accounts for inventory on a LIFO basis, section 337 requires that the LIFO recapture amount be included in income.

Special rules for distributions by S corporations

The Code allows a closely-held business operating in corporate form to elect to have business gains and losses taxed directly to or deducted directly by its individual shareholders. This election is available under Subchapter S of the Code (secs. 1361-1379). The principal advantage of a Subchapter S election to the owners of a business is the ability to retain the advantages of operating in corporate form while avoiding taxation of corporate earnings at both the corporate and shareholder levels.

Prior to 1983, shareholders of corporations making a Subchapter S election were taxed on actual cash dividend distributions of current earnings and profits of the corporation, and on undistributed taxable income as a deemed dividend. Accordingly, all of the taxable income of a corporation taxable under Subchapter S passed

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[14] In the case of a distribution of property that is subject to a liability that is not assumed by the shareholder, the gain recognized is limited to the excess of the property's fair market value over its adjusted basis. See sec. 311(c). If the liability is nonrecourse, however, fair market value is treated as being not less than the amount of the liability. See sec. 7701(g).

[15] Sec. 311(b). Under the last-in, first-out or "LIFO" method of accounting, goods purchased or produced most recently are deemed to be the first goods sold. "FIFO" (first-in, first-out) accounting assumes that the first goods purchased or produced are the first goods sold. The LIFO recapture and installment obligation rules are applied before the recognition rules of section 311(d)(1).

[16] Sec. 453B. Installment obligations received by a corporation in a sale or exchange qualifying for nonrecognition under section 337 may be distributed to shareholders without recognition at the corporate level. Sec. 453B(d)(2).

[17] Sec. 453B(d).

through to its shareholders as dividends. A shareholder increased his basis in his stock by the amount of his pro rata share of undistributed taxable income.

The Subchapter S Revision Act of 1982 substantially modified these rules. The dividends-earnings and profits system was abandoned in favor of a pass-through approach based more closely on the system under which partnership income is taxed. Under these new rules, gain must be recognized by an S corporation (which gain is passed through to its shareholders) on a nonliquidating distribution of appreciated property as if it had sold the property for its fair market value (sec. 1363(d)). The purpose of this rule is to assure that the appreciation does not escape tax entirely. A shareholder in an S corporation generally does not recognize gain on receipt of property from the corporation, but simply reduces his basis in his stock by the fair market value of the property, taking a basis in the property equal to that value. The shareholder can then sell the property without recognizing any gain. Thus, unless the distribution triggered gain at the corporate level, no current tax would be paid on the appreciation in the distributed property.

Liquidating distributions by an S corporation are taxed in the same manner as liquidating distributions of C corporations. Thus, no gain is recognized by the corporation (sec. 1363(e)). Although the *General Utilities* rule in this context is not responsible for the imposition of only a single, shareholder-level tax on appreciation in corporate property,[18] it may allow a portion of the gain that would otherwise be ordinary to receive capital gains treatment.

Statutory law and judicial doctrines affecting application of General Utilities rule

Recapture rules

The nonrecognition provisions of sections 311, 336, and 337 are subject to several additional limitations beyond those expressly set forth in those sections. These limitations include the statutory "recapture" rules for depreciation deductions, investment tax credits, and certain other items that may have produced a tax benefit for the transferor-taxpayer in prior years.[19]

The depreciation recapture rules (sec. 1245) require inclusion, as ordinary income, of any gain attributable to depreciation deductions previously claimed by the taxpayer with respect to "section 1245 property" — essentially, depreciable personal property — disposed of during the year,[20] to the extent the depreciation claimed exceeds the property's actual decline in value.

A more limited depreciation recapture rule applies to real estate. Under section 1250, gain on disposition of residential real property held for more than one year is recaptured as ordinary income to the extent prior depreciation deductions exceed depreciation com-

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[18] A shareholder would under the Subchapter S rules be entitled to a basis increase equal to the amount of gain recognized by the corporation.

[19] These rules apply not just to corporate distributions but to sales and other dispositions of property, other than in tax-free reorganizations.

[20] In the case of sales or exchanges of property in taxable transactions, the effect is to convert a portion of what would otherwise be capital gain into ordinary income. In the case of nonrecognition transactions, the effect is to require recognition of gain that would otherwise go unrecognized.

puted on the straight-line method (sec. 1250). Gain on disposition of nonresidential real property held for more than one year, however, is generally subject to recapture of all depreciation unless a straight-line method has been elected, in which case there is no recapture.[21]

A number of other statutory recapture provisions may apply to a liquidating or nonliquidating distribution of property, including section 617(d) (providing for recapture of post-1965 mining exploration expenditures), section 1252 (soil and water conservation and land-clearing expenditures), and section 1254 (post-1975 intangible drilling and development costs).

Collapsible corporation rules

Section 341 modifies the tax treatment of transactions involving stock in or property held by "collapsible" corporations. In general, a collapsible corporation is one the purpose of which is to convert ordinary income into capital gain through the sale of stock by its shareholders, or through liquidation of the corporation, before substantial income has been realized.

Under section 341, if a shareholder disposes of stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain, the gain is treated as ordinary income. Likewise, any gain realized by a shareholder on a liquidating distribution of appreciated property from a collapsible corporation will be ordinary income. Finally, section 337 is inapplicable in the case of a collapsible corporation. Thus, liquidating sales of appreciated inventory or other property held by the corporation for sale to customers generate ordinary income which is fully recognized at the corporate level.[22]

Certain stock purchases treated as asset purchases

Section 338 of the Code permits a corporation that purchases a controlling stock interest in another corporation (the "target" corporation) within a twelve-month period to elect to treat the transaction as a purchase of the assets of that corporation for tax purposes. If the election is made, the target is treated as if it had sold all of its assets pursuant to a plan of complete liquidation under 337 on the date the purchaser obtained a controlling interest in the target (the "acquisition date"), for an amount essentially equal to the purchase price of the stock plus its liabilities. Accordingly, no gain is recognized on the deemed sale other than gain attributable to section 1245 or other provisions that override section 337. The target is then treated as a newly organized corporation which purchased all of the "old" target's assets for a price essentially equal to the purchase price of the stock plus the old target's liabilities on the beginning of day after the qualified stock purchase. Thus, the new target corporation may obtain a stepped-up basis in its assets equal to their fair market value.

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[21] Sec. 1245(a)(5).

[22] Gain on sales of capital or section 1231 assets in a section 337 liquidation of a collapsible corporation may be taxed at capital gains rates. A sale in liquidation may produce corporate level income that eliminates the collapsible status of the corporation, so that the shareholders will receive capital gains treatment on relinquishment of their shares in the liquidation.

Prior to the enactment of section 338, similar results could be achieved under section 332 and former section 334(b)(2) by liquidating the acquired corporation into its parent within a specified period of time. One abuse Congress sought to prevent in enacting section 338 was selective tax treatment of corporate acquisitions. Taxpayers were able to take a stepped-up basis in some assets held by a target corporation or its affiliates while avoiding recapture tax and other unfavorable tax consequences with respect to other assets.[23] Section 338 contains elaborate "consistency" rules designed to prevent selectivity with respect to acquisitions of stock and assets of a target corporation (and its affiliates) by an acquiring corporation (and its affiliates). All such purchases by the acquiring group must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one year before and ending one year after the twelve-month acquisition period.[24]

Judicially created doctrines

The courts have applied nonstatutory doctrines from other areas of the tax law to in-kind distributions to shareholders. For example, it has been held that where the cost of property distributed in a liquidation or sold pursuant to a section 337 plan of liquidation has previously been deducted by the corporation, the tax benefit doctrine overrides the statutory rules to cause recognition of income.[25] The application of the tax benefit doctrine turns on whether there is a "fundamental inconsistency" between the prior deduction and some subsequent event.[26]

The courts have also applied the assignment of income doctrine to require a corporation to recognize income on liquidating and nonliquidating distributions of its property.[27]

Reasons for Change

The committee believes that the *General Utilities* rule, even in the more limited form in which it exists today, produces many incongruities and inequities in the tax system. First, the rule may create significant distortions in business behavior. Economically, a liquidating distribution is indistinguishable from a nonliquidating distribution; yet the Code provides a substantial preference for the former. A corporation acquiring the assets of a liquidating corporation is able to obtain a basis in assets equal to their fair market value, although the transferor recognizes no gain (other than possibly recapture amounts) on the sale. The tax benefits may make the assets more valuable in the hands of the transferee than in the

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[23] Prior to TEFRA, a step-up could be achieved through a partial liquidation of the target as well as a complete liquidation under sections 332 and 334(b)(2).

[24] Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of property is carried over, and other asset acquisitions as provided in regulations.

[25] *See, e.g., Bliss Dairy* v. *United States*, 460 U.S. 370 (1983) and *Tennessee Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440 (1975), *aff'd* 582 F.2d 378 (6th Cir. 1978) (liquidating distribution of previously expensed items); *Estate of Munter* v. *Commissioner*, 63 T.C. 663 (1975) (sale of previously deducted items pursuant to plan of liquidation).

[26] *Bliss Dairy, supra.*

[27] *E.g., Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir.), *cert denied*, 335 U.S. 867 (1948) (a decision rendered prior to the enactment of sec. 311); *Siegel* v. *United States*, 464 U.S. 891 (1972), *cert. dism'd*, 416 U.S. 918 (1973).

hands of the present owner. The effect may be to induce corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might indicate a different course of action. Accordingly, the *General Utilities* rule may be responsible, at least in part, for the dramatic increase in corporate mergers and acquisitions in recent years. The committee believes that the Code should not artificially encourage corporate liquidations and acquisitions, and believes that repeal of the *General Utilities* rule is a major step towards that goal.

Second, the *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax.[28] Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax.

Although the committee believes that some relief from the two-tier tax on corporate earnings should be provided, and understands that the *General Utilities* rule serves this purpose, the committee believes that there is a more efficient and equitable method of providing relief. Partial relief from the two-tier tax in the case of earnings distributed as dividends is provided elsewhere in the bill in the form of a dividends paid deduction.[29] The committee has also provided relief from recognition in this provision for liquidating distributions in situations similar to those for which relief is provided under present law for nonliquidating distributions of corporate property.

Explanation of Provisions

Overview

The bill provides that gain or loss generally is recognized by a corporation on liquidating distributions of its property as if the property had been sold at fair market value. Gain or loss is also recognized by a corporation on liquidating sales of its property. An exception is provided for gain or loss on specified types of property allocable to shares held by certain noncorporate shareholders, under rules similar to present-law rules applicable to nonliquidating distributions. Exceptions are also provided for distributions by a controlled subsidiary in a liquidation under section 332 (to the extent gain or loss is allocable to shares held by the parent corporation), and distributions and exchanges involving property that may be received tax-free under the reorganization provisions of the Code.

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[28] The price of this basis step up is, at most, a single shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax is deferred because the shareholder's gain is reported under the installment method.

[29] *See* Part B, *supra*.

Distributions in liquidation

General rule

The bill provides that, in general, gain or loss is recognized to a corporation on a distribution of its property in complete liquidation. The distributing corporation is treated as if it had sold the property at fair market value to the distributee-shareholders.[30] If the distributed property is subject to a liability, or the shareholders assume a liability in connection with the distribution, and the amount of the liability exceeds the fair market value, the value of the property is deemed to be the amount of the liability. Thus, in this situation, gain is generally recognized to the extent the liability exceeds the distributor's basis.

Exceptions

Section 332 liquidations

An exception to the recognition rule is provided for liquidations in which a 100-percent controlled subsidiary is liquidated into its parent corporation in a liquidation to which section 332 applies.[31] If the stock of the liquidating corporation is owned both by an 80-percent or more corporate shareholder qualifying under section 332 (an "80-percent distributee")[32] and minority shareholders, nonrecognition applies to that portion of each gain and loss that is allocable to the controlling corporation's stock. Thus, nonrecognition in this situation is limited to the controlling shareholder's percentage ownership by value in the distributing corporation multiplied by the amount of gain or loss realized on each asset distributed, irrespective of whether the asset is received by the controlling shareholder or a minority shareholder. The balance of each gain and loss is recognized except to the extent the qualified stock exception described below applies.

The percentage ownership of a controlling corporation is determined as of the date of the adoption of plan of liquidation. The committee intends that, in general, the date of adoption of the plan is the date on which a resolution authorizing the liquidation is formally adopted by the corporation's shareholders.[33] A special rule permits the 80-percent distributee to include in its ownership percentage as of the date of adoption of the plan any stock in the subsidiary that is (1) purchased by the 80-percent distributee for cash after adoption of the plan of liquidation or (2) redeemed for cash by the subsidiary in the liquidation. Stock is not eligible for this special rule, however, if it is redeemed by the subsidiary (or purchased by the controlling corporation) for cash following a "qualified section 332 liquidation." A qualified section 332 liquidation in general is one in which a lower-tier subsidiary sells its assets within a twelve-month period following the adoption of a plan of liquidation,

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[30] For this purpose, a pro rata portion of each asset is deemed to be sold to each shareholder, regardless of the identity of the actual distributee.

[31] In such a case, the distributee corporation would take a carryover basis under section 334(b)(1).

[32] The committee anticipates that, in a consolidated return context, the Treasury Department will consider whether aggregation of ownership rules similar to those in sec. 1.1502-34 of the regulations should be provided for purposes of determining status as an 80-percent distributee.

[33] See Treas. Reg. sec. 1.337-2(b).

and the subsidiary and all corporations above it in the chain are liquidated.

Distributions with respect to qualified stock

Under the bill, a corporation that is an "active business corporation" does not recognize gain or loss on liquidating distributions to the extent that its stock is "qualified stock". Nonrecognition applies to the "applicable percentage" of gain or loss on each asset distributed and (as under the 80-percent distributee exception) is determined without regard to whom the property is actually distributed (i.e., without regard to the actual distributee's status as a holder of qualified stock). The applicable percentage for this purpose is the portion by value of the liquidating corporation's stock that is qualified stock on the date of adoption of the plan of liquidation.

Property ineligible for nonrecognition.—Gains and losses on certain types of property are ineligible for nonrecognition under this exception, even if allocable to qualified stock. All gains and losses that are ordinary (e.g., derived from inventory items or items held for sale to customers) or are attributable to short-term capital assets are recognized, regardless of whether they are allocable to qualified stock. In addition, gain is recognized to the extent section 453B (relating to dispositions of installment obligations) applies.

Qualified stock.—The definition of qualified stock is similar to the definition of qualified stock under section 311 of present law.[34] In general, under the bill, qualified stock is stock that has been held by a noncorporate shareholder for at least a five-year period (or the life of the corporation, if less than five years) during which such shareholder held at least 10 percent in value of the outstanding stock of the liquidating corporation.[35] The section 318 attribution rules apply, with certain modifications that expand attribution from and to family members.[36] The committee anticipates that the Treasury regulations issued under this provision will provide rules to prevent any share of stock from being treated as owned simultaneously by more than one person as a result of attribution.[37]

In addition, any person who inherits stock or otherwise acquires stock upon the death of an individual may include the holding period of the decedent in determining the period of ownership. The bill provides that "look through" rules that are similar to those under section 311 shall apply for determining qualification of stock held by partnerships, estates, and other pass-through entities.

Active business corporation.—An "active business corporation" is a corporation substantially all of whose assets consist of the assets of one or more qualified businesses, and no substantial part of

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[34] The bill conforms the definition of qualified stock under section 311 with the definition under this provision.

[35] Thus, unlike present law section 311(e)(1), not all stock held by a 10-percent, five-year shareholder will necessarily be qualified stock.

[36] The bill adopts the broader definition of family in section 267(c)(4) and extends it to spouses of persons described in that section.

[37] For example, if a husband and wife each own 5 percent of the stock of a corporation (and the remaining shares are widely dispersed among unrelated persons), each would hold 5 percent directly and 5 percent by attribution and thus would be 10-percent shareholders (and their stock would be qualified stock, assuming the holding period requirement is met). The applicable percentage, however, would be 10 percent, not 20 percent).

whose nonbusiness assets were acquired in a section 351 transfer or as a capital contribution within the previous five years. A qualified business is a trade or business actively conducted for five years and not acquired within the five years in a transaction in which gain or loss was recognized.[38] For this purpose, the committee intends that a corporation will be treated as owning a proportionate share of the assets of each other corporation in which it owns 50 percent or more in value of the outstanding stock, for the period during which it held such 50-percent or more interest.

Tax-free reorganizations and distributions

The bill provides that the general rule requiring recognition of gain or loss on distributions in liquidation does not apply with respect to any exchange or distribution of property to the extent there is nonrecognition of gain or loss to the distributee under the provisions of the Code relating to corporate reorganizations and distributions. For example, if a corporation transfers its assets to another corporation in a type "C" reorganization, receiving only stock of the acquiring corporation, and distributes all of the stock in liquidation to its shareholders, the liquidating corporation will recognize no gain or loss on the distribution of the stock.

If the liquidating corporation transfers substantially all (but not all) of its assets to the acquiring corporation, however, and distributes the remaining assets to its shareholders along with the acquiring corporation's stock, the assets will constitute "boot" and will be taxable to the distributee-shareholder. Accordingly, the general recognition rule for corporate distributions will apply to the boot unless a portion of the gain is allocable to qualified stock and the other requirements of the qualified stock exception are satisfied.

Similarly, in a "split-up" under section 355, no gain is recognized to the liquidating corporation with respect to the stock or securities of the controlled subsidiary distributed to shareholders. Gain generally is recognized, however, to the extent the distribution includes appreciated property constituting boot.[39]

Recognition under other rules

In providing exceptions to this provision requiring recognition of gain on corporate liquidations, the committee does not intend to supersede other existing statutory rules and judicial doctrines (including, but not limited to, section 1245 and section 1250 recapture, the tax benefit doctrine, and the assignment of income doctrine). The committee intends that these rules will continue to cause recognition of income or gain on distributions of property where they are otherwise applicable.

Liquidating sales of property (sec. 337)

The bill amends section 337 to provide for nonrecognition of gain or loss to a liquidating corporation on a sale of assets to the same extent nonrecognition would have been available on a liquidating

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[38] See sec. 311(e)(2)(B)(i).

[39] See also section 361, as amended by the section 1504 of Title XV of the bill (relating to Technical Corrections to the Tax Reform Act of 1984) clarifying that a transferor corporation that is a party to a reorganization recognizes no gain or loss on any disposition of stock or securities received from another party to the reorganization.

distribution, with certain modifications. As under present law, in order for this provision to apply, the corporation must adopt a plan of complete liquidation and distribute all of its assets (except assets retained to meet claims) within twelve months after adoption of the plan.

If the liquidating corporation does not have a controlling corporate shareholder, gain or loss from the sale of assets is not recognized to the extent allocable to qualified stock (subject to the restrictions set forth in section 336). If the liquidation is of a controlled subsidiary that would qualify for the section 332 liquidation exception to section 336, nonrecognition is available only if the liquidation is a "qualified section 332 liquidation." A qualified liquidation is one in which the liquidating corporation, and each corporate distributee above it in the chain that is entitled to receive a distribution without recognition of gain under section 332, liquidates (other than in a section 333 liquidation) within the twelve-month period following adoption of a plan of liquidation.[40]

In the case of a qualified section liquidation, the corporation selling its assets and each corporate distributee in the chain required to be liquidated are deemed to have received a distribution of the assets disposed of in the liquidating sale or sales, if more than one subsidiary in the chain sells assets), and to have distributed those assets in liquidation. Thus, gain or loss on the sale or exchange of assets by any controlled subsidiary in an affiliated group will be recognized to the same extent gain or loss would have been recognized if such assets had been actually distributed up the chain to the last 80-percent distributee in section 332 liquidations, and then distributed to the shareholders of such corporation in liquidation.[41]

The bill provides that loss is not recognized to the corporation on any sale or exchange of property during the one-year period ending on the date of the adoption of a plan of liquidation, or at any time after the adoption of such a plan, to the extent the corporation would be eligible for nonrecognition under one of the exceptions to section 336 if the property had been distributed. Thus, for example, if the applicable percentage in a liquidation were 40 percent, a sale of an asset, whose adjusted basis exceeded its fair market value, at any time following the adoption of the plan would result in 40 percent nonrecognition of the loss. This loss disallowance rule does not apply to sales or exchanges in the ordinary course of the corporation's business.

Consistent with present law, the bill provides that nonrecognition treatment is not available in the case of a sale or exchange by a collapsible corporation within the meaning of section 341, or by a corporation that has adopted a plan of liquidation to which section

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[40] This is similar to present-law section 337(c)(3), which allows a lower tier controlled subsidiary to avail itself of section 337 nonrecognition if all 80-percent corporate distributees above it are liquidated.

[41] Thus, assuming twelve equal shareholders own stock that is not qualified stock in a holding company that owns 100 percent of target corporation, the sale of target assets after the adoption of a plan of liquidation will be subject to full recognition even if the entire chain liquidates within twelve months from the time the plan is adopted. The assets sold by target are tested for recognition by deeming them to have been distributed from target to parent and then to parent's shareholders. The assets sold or exchanged under section 337 will also be deemed distributed through the entire corporate chain for purposes of determining whether the common parent is an active business corporation.

333 applies. Also consistent with present law, inventory items and other property held for sale to customers, and installment obligations acquired in a sale or exchange of such property (whether acquired before or after the adoption of the plan of liquidation), are not eligible for nonrecognition treatment.[42] Installment obligations received in liquidating sales within the twelve-month period are eligible for nonrecognition only to the extent a distribution of the property for which they were received would have qualified for nonrecognition. The special rule under present law that allows nonrecognition treatment for certain involuntary conversions preceding adoption of a plan of liquidation is also preserved.

Stock purchases treated as asset purchases (sec. 338)

Under the bill, section 338 of present law is retained, but in general no longer allows nonrecognition of gain or loss on the deemed sale of the target corporation's assets. An exception is provided for qualified stock purchases within the meaning of section 338 of present law where one or more shareholders of the target corporation hold qualified stock and the target is an active business corporation. Where this exception applies, the amount of gain or loss recognized on the deemed asset sale is determined as if the target corporation had distributed all of its assets in liquidation on the acquisition date. The rules of section 336 therefore determine the amount of gain or loss recognized.[42a] However, the exception to recognition under section 336 for gain or loss allocable to the shares of an 80-percent corporate shareholder is not available in this situation. Accordingly, a purchase of stock from an 80-percent or more corporate shareholder followed by a section 338 election will result in recognition of gain or loss to the target corporation to the full extent gain or loss is allocable to such stock (assuming the 80-percent corporate shareholder does not liquidate in a qualified section 332 liquidation and the stock of the corporate shareholder is not qualified stock). If the 80-percent corporate shareholder liquidates in a qualified section 332 liquidation, the committee intends that the target stock will be deemed to have been distributed through the entire corporate chain and then sold by the parent's shareholders to the acquiring corporation. Therefore, if the parent's shareholders own qualified stock, no gain would be recognized as a result of the section 338 election.

S corporations

The bill provides a special rule for liquidations of S corporations where the corporation was formerly a C corporation and the liquidation occurs before the close of the second taxable year following the year in which the election to be an S corporation took effect. In this case, the subchapter S election is terminated retroactively to the first taxable year for which it was effective. The bill extends the statute of limitations for any deficiency attributable to this ter-

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[42] In addition, no exception is included for a bulk sale of inventory, as currently exists under section 337(b)(2).

[42a] Appropriate adjustments to the applicable percentage will be made to take into account any stock of the target corporation retained by holders of qualified stock.

mination to the date one year after the date the liquidation is completed.

Effective Dates

In general

The bill applies to distributions or sales and exchanges occurring on or after November 20, 1985, and to any transaction described in section 338 of the Code for which the acquisition date occurs on or after November 20, 1985.

Thus, the bill does not apply to deemed sales under a timely section 338 election that is made on or after November 20, 1985, if the acquisition date occurred before November 20, 1985.

Transitional rules

The bill has several date transitional rules. The general transitional rule is that the bill does not apply to distributions or sales and exchanges made pursuant to a plan of liquidation adopted before November 20, 1985.

Special rules apply for purposes of determining whether a plan of liquidation has been adopted for this purpose and whether a distribution, sale, or exchange is made pursuant to such a plan of liquidation. In general, the rules are intended to provide relief in situations in which a decision to liquidate has clearly been made regarding an acquisition, or a decision regarding acquisition has been made and the essential terms have been determined. Some transactions may qualify for relief under more than one provision.

First transitional rule

The first rule under which a distribution, sale or exchange will be treated as pursuant to a plan of liquidation adopted before November 20, 1985 looks to action taken by the liquidating company before the November 20 date. If the board of directors of that company adopted a resolution to solicit shareholder approval for a transaction described in section 336 or 337[43] or if the shareholders or board of directors of the liquidating company have approved such a transaction, then distributions, sales and exchanges that occur pursuant to the transaction will not be subject to the bill provided that an actual plan of complete liquidation is adopted before January 1, 1988, and at least one sale or distribution pursuant to such plan is made before that date.

Pre-November 20 action

For purposes of this rule, certain actions taken before November 20, 1985, are intended to constitute implicitly the necessary board of directors or shareholder approval even though formal board of shareholder approval may not otherwise have occurred before that date. The committee intends the requisite board or shareholder approval will be deemed to have occurred if, before November 20, 1985, there was sufficient written evidence to establish that a deci-

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[43] For purposes of the transitional rules generally, transactions described in section 336 or 337 include complete liquidations and the related distributions, sales or exchanges described in those sections under present law.

sion to liquidate has been approved by the board of directors or shareholders, even though the approval may have been given informally, as may occur, for example, in a closely held setting. Examples of sufficient written evidence include written contacts with third parties indicating the decision to liquidate and seeking any necessary approvals for asset transfers or for other actions in connection with the liquidation.

The committee also intends that the requisite board or shareholder approval would be deemed to have occurred, if a company has, before November 20, 1985, entered into a binding contract to sell substantially all of its assets, or has entered into a letter of intent with a buyer specifying the essential terms of such a contract.[44]

"Pursuant to" requirement

To qualify for transitional relief, distributions, sales or exchanges must be pursuant to the transaction that the board of directors approved, or for which it solicited shareholder authority (as described above). This will generally be presumed to be the case if a formal plan of liquidation is adopted and the distributions, or sales and exchanges pursuant to such plan commence within one year of the original shareholder or board action. If such action is not taken within a year of such time, all the facts and circumstances must be considered, including, for example, a decision to seek a ruling request from the Internal Revenue the need to obtain governmental rulings or approvals, or third party approvals for asset transfers. If the requisite shareholder or board approval is reflected in a binding contract or letter of intent, the specified sale must thereafter be consummated in accordance with the contract or letter of intent and the formal plan of liquidation be adopted as required above.

Second transitional rule

Under a second transitional rule, sales or distributions pursuant to a plan of liquidation (which includes, for purposes of the rules, a section 338 election) will not be affected by the bill if, before November 20, 1985, (i) there has been an offer to purchase a majority of the voting stock of the liquidating corporation, or (ii) the board of directors of the liquidating corporation has adopted a resolution approving an acquisition of the company or recommending the approval of an acquisition of the company to the shareholders; provided in each case the sale or distribution is pursuant to or was contemplated by the terms of the offer or resolution, and a plan of complete liquidation is adopted (or a section 338 election is made) before January 1, 1988. There must also be at least one sale or distribution pursuant to such plan of liquidation before January 1, 1988. The term liquidating corporation includes an acquired corpo-

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[44] As an example, if prior to November 20, 1985, the company has entered a letter of intent specifying that either substantially all the assets of the company will be sold to a particular purchaser or purchasers for a particular price, or that all the stock of the company will be sold to such persons (who may then liquidate the corporation or make a section 338 election) it would generally be considered that the requisite shareholder or board approval of a transaction described in section 337 has occurred if the contract to sell assets is in fact entered and the corporation liquidates in a transaction described in section 337. The same transaction could qualify under the transition rule for an offer to aquire stock if the contract to sell stock were entered (and the purchaser made a section 338 election or liquidated the corporation).

ration (and affiliates) with respect to which a section 338 election is made.

Pre-November 20 action

An offer to purchase a majority of the stock of a corporation is intended to include a tender offer or a binding option given by the offeror and enforceable by the offeree. The committee also intends that an offer for this purpose would include a letter of intent entered into by the purchaser and seller specifying the essential terms of an acquisition. Any binding contract to acquire a corporation presuppose an offer (as well as the approval and acceptance of the required corporation's shareholders or board of directors). The committee does not intend that a nonbinding offer, as to which there has been no implicit or explicit approval by the board of directors or shareholders of the corporation to be acquired, would be within the scope of the transition rule.

"Pursuant to" requirement

For purposes of the transitional rules, in determining whether a sale or distribution is pursuant to or was contemplated as part of a transaction, the committee intends that deemed sales or exchanges pursuant to a timely section 338 election made with respect to a qualified stock purchase will be presumed to be pursuant to and contemplated by the terms of a pre-November 20 offer or of a board-approved or recommended acquisition that resulted in the purchase. For example, if, prior to November 20, the board of directors of a corporation adopted a resolution approving the acquisition of that corporation and if, after November 20, the acquisition occurs and a timely section 338 election is made prior to January 1, 1988 with respect to the acquired company and its affiliates, the deemed sales pursuant to the section 338 election will not be affected by the bill. In addition, if a corporation qualifies for this transitional rule by virtue of a letter of intent or binding contract the acquisition must occur in accordance with the letter or contract.

The committee also intends that distributions, sales or exchanges will generally be considered pursuant to and contemplated by an acquisition transaction if a formal plan of liquidation is adopted within one year after the acquisition is consummated and the distributions, sales or exchanges commence within that time. However, the committee intends that if such actions commence more than one year after the acquisition, a determination whether the distributions, sales or exchanges are pursuant to or were contemplated by the terms of the offer will be determined on the basis of all the facts and circumstances. Such circumstances include, but are not limited to, references to or statements regarding the possibility of a liquidation made in the acquisition documents, proxy material or other correspondence with shareholders, public announcements, or requests for governmental approvals, as well as internal documentation and correspondence with attorneys or others involved in the acquisition.

Third transitional rule

Under the third transitional rule, distributions, sales or exchanges in a liquidation (including a section 338 election) are not

affected by the amendments under the bill if prior to November 20 a ruling request was submitted to the Internal Revenue Service with respect to a transaction (which transaction includes or contemplates a transaction described in section 336 or 337 (including a section 338 election)), and, pursuant to the transaction described in the ruling request, a plan of complete liquidation (or a sec. 338 election is made) is adopted, and at least one sale or distribution pursuant to such plan occurs, before the later of January 1, 1988 or 90 days after the date of the ruling.

Related corporations

In applying the transitional rules, action (as described above) taken by the board of directors or shareholders of a corporation with respect to a subsidiary of such corporation is treated as taken by the board of directors or shareholders of such subsidiary. For example, if the board of directors of a parent corporation has adopted a resolution approving the sale of substantially all the assets and subsequent liquidation of the subsidiary, that action would be considered action of the shareholders and board of the subsidiary regardless of how many tiers below the parent the subsidiary may be (so long as the parent has effective control over the subsidiary).

In certain instances involving a group of several tiers of subsidiaries, even though the parent corporation has not formally adopted such a resolution, the action of a lower-tier subsidiary may be considered evidence of implicit action by the parent. For example, in the case of the liquidation of a group of corporations constituting an affiliated group involving sales under present law section 337, all distributee members of the group must liquidate within one year. If one member of such group has prior to November 20, 1985, taken board or shareholder action of the type qualifying for transition relief (as described above) and if that member and the other members do liquidate within the required one year period, it is intended that timely approval by the board or shareholders of the parent corporation of the group will generally be presumed. In other situations involving pre-November 20 action by only one member of a group of commonly controlled corporations, whether that action can be attributed to members of the group other than an effectively controlled subsidiary of the acting corporation will be determined on the basis of all the facts and circumstances.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $471 million in 1986 and by $441 million in 1987, and to increase fiscal year budget receipts by $171 million in 1988, $991 million in 1989, and $1,967 million in 1990.

TITLE IV—TAX SHELTER PROVISIONS

A. Extension of At-Risk Rules to Real Estate Activities (Sec. 401 of the bill and sec. 465 of the Code)

Present Law

Loss limitation rules

Present law (Code sec. 465) provides an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate active business activities, applicable to individuals and to certain closely held corporations.[1] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security for repayment property not used in the activity. This amount is generally increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans); or (2) the lender has an interest (other than as a creditor) in the activity (except to the extent provided in Treasury regulations). The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance) or similar arrangements. Losses which may not be deducted for any taxable year because of the loss limitation at-risk rule may be deducted in the first succeeding year in which the rule does not prevent the deduction.

The loss limitation at-risk rule is applicable to individuals and to closely held corporations more than 50 percent in value of the stock in which was owned, at anytime during the last half of the taxable year, by or for 5 or fewer individuals. Stock ownership is generally determined according to the rules applicable for purposes

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[1] The Tax Reform Act of 1976 (P.L. 94-455) applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978 (P.L. 95-600) extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations. The Tax Reform Act of 1984 (P.L. 98-369) created an exception for certain active businesses of closely held C corporations.

of identifying a personal holding company (sec. 542(a)(2)). In the case of a partnership or S corporation, the rules apply at the partner or shareholder level respectively.

Generally, a taxpayer's amount at risk is separately determined with respect to separate activities. Nevertheless, activities are treated as one activity (i.e., aggregated) if the activities constitute a trade or business and (1) the taxpayer actively participates in the management of that trade or business, or (2) in the case of a trade or business carried on by a partnership or S corporation, 65 percent or more of losses is allocable to persons who actively participate in the management of the trade or business. The Treasury has authority to prescribe regulations under which activities are aggregated or treated as separate activities.[2] In addition, an exception from the at-risk rules is provided for certain active business activities of closely held corporations, and for this purpose, the component members of an affiliated group are treated as a single taxpayer (sec. 465(c)(7)(F)).

Investment tax credit rules

Present law also provides rules requiring the taxpayer to be at-risk with respect to property in order to qualify for the investment tax credit (sec. 46(c)(8)). These rules provide an exception where the property is financed by certain third party nonrecourse loans.

Reasons for Change

The committee believes it is appropriate to apply the at-risk rules to real estate activities so as to limit the opportunity for overvaluation of property (resulting in inflated deductions).

The bill therefore extends the present law at-risk rules to real estate, with an exception for certain arm's-length third party nonrecourse financing. This is intended to reduce the incentive for overvaluation of property.

Nonrecourse financing by the seller of real property (or a person related to the seller) is not treated as an amount at risk under the bill, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of arm's length third party commercial financing secured solely by the real property, however, the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity.

Explanation of Provision

Under the bill, the present law at-risk rules are extended to the activity of holding real property. In the case of such an activity, the bill provides an exception for certain third-party nonrecourse financing which is secured by real property used in the activity; the taxpayer is treated at-risk with respect to such financing.

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[2] Similar rules apply in the case of activities described in section 465(c)(2)(A) (which includes certain motion picture, farming, leasing, oil and gas and geothermal deposit activities).

Qualified nonrecourse financing

The exception provided for qualified nonrecourse financing is similar to the rules for qualified commercial financing under the investment tax credit at-risk rules under present law. Qualified nonrecourse financing generally includes financing (other than convertible debt) that is secured by real property used in the activity and that is loaned or guaranteed by any Federal, State, or local government, or borrowed by the taxpayer from a qualified person, with respect to the activity of holding real property (other than mineral property), provided such amounts are not used to acquire an interest in property from a related person.

For this purpose, nonrecourse financing means financing with respect to which no person is personally liable, except to the extent otherwise provided in regulations. Regulations may set forth the circumstances in which guarantees, indemnities, or personal liability (or the like) of a person other than the taxpayer will not cause the financing to be treated as other than qualified nonrecourse financing.

Qualified persons include any person actively and regularly engaged in the business of lending money. However, qualified persons do not include (1) any person related to the taxpayer; (2) any person from which the taxpayer acquired the property (or a person related to such person); or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). For these purposes, the bill adopts the definition of related person applicable under the investment tax credit at-risk rules, which is set forth in section 461(i)(6) as amended by the bill. Under this rule, related persons generally include family members, fiduciaries, and corporations or partnerships in which a person has at least a 10-percent interest.

A special rule for partnerships provides that partnership-level qualified nonrecourse financing may increase a partner's (including a limited partner's) amount at risk, determined in accordance with his share of the liability (within the meaning of section 752), provided the financing is qualified nonrecourse financing with respect to that partner as well as with respect to the partnership. For the purpose of determining whether partnership borrowings are treated as qualified nonrecourse financing with respect to the partnership, the partnership is treated as the taxpayer. For the purpose of determining whether a share of partnership borrowings is treated as qualified nonrecourse financing with respect to a partner, the partner is also treated as the borrower. The amount for which partners are treated as at risk under this rule may not exceed the total amount of the qualified nonrecourse financing at the partnership level.

In the case of property taken subject to a nonrecourse debt which constituted qualified nonrecourse financing in the hands of the original borrower, such debt may be considered as qualified nonrecourse financing as to the original borrower's transferee, provided that all the criteria for qualified nonrecourse financing are satisfied for that debt with respect to the transferee. The same rule applies to subsequent transfers of the property taken subject to the debt, and to the admission of new partners to a partnership (or sale

or exchange of a partnership interest), so long as the debt constitutes qualified financing with respect to each transferee or new partner.

Aggregation rules

The present law at-risk aggregation rules (sec. 465(c)(3)(B)) generally apply to the activity of holding real property. Under these rules, it is intended that if a taxpayer actively participates in the management of several partnerships each engaged in the real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity with respect to that partner for purposes of the at-risk rules. Also it is intended that the regulations relating to the treatment of at-risk amounts in the case of an affiliated group of corporations (Treasury reg. sec. 1.1502-45) be appropriately modified, in the case of an affiliated group which is engaged principally in the real estate business, to allow aggregation of the real estate activities, where the component members of the group are actively engaged in the management of the real estate business (not including real estate financing other than between members of the affiliated group).

Effective Date

The provision applies to losses attributable to property acquired after December 31, 1985. In the case of a partnership or S corporation, property acquired means property owned by the partnership or S corporation and also an interest in the partnership or stock in the S corporation.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $7 million in 1986, increase fiscal year budget receipts by $2 million in 1987, decrease fiscal year budget receipts by $2 million in 1988, and increase fiscal year budget receipts by $24 million in 1989, and $22 million in 1990.

B. Interest Deduction Limitations (Sec. 402 of the bill and sec. 163(d) of the Code)

Present Law

In general

Under present law (Code sec. 163(d)), in the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment are generally limited to $10,000 per year, plus the taxpayer's net investment income. Investment interest paid or accrued during the year which exceeds this limitation is not permanently disallowed, but is subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation) (sec. 163(d)(2)). Interest incurred to purchase or carry certain property that is subject to a net lease generally is treated as investment interest, if certain trade or business deductions are less than 15 percent of the rental income, or if the lessor is guaranteed a specific return or is guaranteed against loss of income.

Income and interest of partnerships and S corporations generally retain their entity level character (as either investment or non-investment interest or income) in the hands of the partners and shareholders. The present-law treatment of interest incurred to purchase or carry a partnership interest or S corporation stock is not entirely clear.[3]

Under present law, no limitation is imposed under section 163(d) on the deductibility of either interest on indebtedness incurred to purchase or carry consumption goods, (i.e., personal (consumer) interest), or interest on indebtedness incurred in connection with the taxpayer's trade or business.

Investment income and expenses

Investment income.—Investment income under present law is income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245, 1250, and 1254), but only if the income is not derived from the conduct of a trade or business (sec. 163(d)(3)(A)).

Investment expenses.—In determining net investment income, the investment expenses taken into account are trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income,

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[3] Proposed Treas. Reg. sec. 1.57-2(b)(2)(i) implies that the interest would not be investment interest where the underlying assets are not investment assets. Compare Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 4.05 (relating to sec. 265 of the Code), and sec. 163(d)(7); see H.R. Rep. No. 97-760, 97th Cong., 2d Sess. at 476-477 (1982).

and depletion, to the extent these expenses are directly connected with the production of investment income.

For purposes of this determination, depreciation with respect to any property is taken into account on a straight-line basis over the useful life of the property, and depletion is taken into account on a cost basis.

Reasons for Change

Present law excludes or mismeasures certain important sources of investment income. The rental value of owner-occupied housing and consumer durables, for example, is not taxed under present law.[4] Similarly, certain types of investments produce a high proportion of their return in forms such as capital gains that are taxed at preferential rates; since capital gains generally are taxed only when realized, recognition of the income may be substantially deferred as well.

The committee recognizes that under present law, the current deduction of interest on indebtedness relating to property, the income from which is not taxed or is taxed only at some future time, results in the deferral and conversion to capital gain income of any gain resulting from an increase in value in the property. This mismeasurement of income can be corrected at least in part by deferral of the interest deductions.

In addition, the committee recognizes that the status of a passive investor in a limited partnership or an S corporation is more like that of a taxpayer holding corporate stock than that of a taxpayer actively conducting a trade or business, because of the investor's limited liability and lack of active participation in management. Limited partnership interests, for example, are generally treated as "securities" for purposes of Federal and State securities laws.

The committee finds it appropriate to treat such interests in enterprises in whose management the taxpayer does not actively participate as investment property. To the extent that the dividing line between an investment activity and a business activity depends upon the status of the taxpayer as an active participant in the underlying trade or business, an interest in an enterprise held by a limited entrepreneur, who does not actively participate in the management of the enterprise, also should be treated as investment property for this purpose. Accordingly, interest deductions relating to such investment property are subject to the limitation on the deductibility of nonbusiness interest under the bill.

While the committee recognizes that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the committee nevertheless believes that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or on a second home, to the extent of the fair market value of the principal residence (or second home).

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[4] By contrast, rental costs of obtaining the use of similar property not owned by the taxpayer must be paid out of after-tax dollars.

Under present law, the computation of net investment income measures depreciation using straight-line depreciation over the useful life of the property. Thus, any reduction in taxable investment income attributable to incentive depreciation deductions is allowable in full without reducing net investment income and, accordingly, without reducing the amount of investment interest currently deductible. The effect of the provision is that availability of tax shelters may not be sufficiently restrained under present law since passive investors are able to take advantage of both the deductibility of interest in full plus the full depreciation deductions, which together may provide substantial mismeasurement of income.

Under present law, leased property is treated as investment property if certain out-of-pocket trade or business deductions attributable to the property are less than 15 percent of the rental income from the property. If, in an effort to reduce out-of-pocket costs, an owner of rental property performs management and repair services, the costs deductible as trade or business expenses may be reduced below 15 percent of rental income, even though the taxpayer may be actively managing the property. The problem may be particularly acute for taxpayers who have relatively small amounts of rental property. In such circumstances, the committee believes, it would be appropriate to permit the taxpayer to include the value of his personal management and repair services along with actual out-of-pocket expenses for purposes of the 15 percent test.

Explanation of Provision

In general

The bill expands the scope of the interest limitation, and alters the calculation of the amount of the limitation. Under the bill, all nonbusiness interest is subject to the limitation on deductibility, including consumer interest and certain interest that is not treated as investment interest subject to limitation under present law. Nonbusiness interest subject to the limitation under the bill does not include interest on debt secured by the taxpayer's principal residence (to the extent of its fair market value), and interest on debt secured by a second residence of the taxpayer (to the extent of its fair market value). Interest expense that is paid or incurred in carrying on a trade or business (except for interest attributable to certain limited business interests not involving low-income housing), is not subject to the interest deduction limitation under the bill.

In general, under the bill the deduction for all nonbusiness interest is limited to the sum of (1) net investment income; and (2) $10,000 ($20,000 in the case of a joint return).

Residences of the taxpayer

Interest on debt secured by a security interest perfected under local law on the taxpayer's principal residence and a second residence of the taxpayer is not treated as nonbusiness interest subject to the limitation under the bill. The taxpayer's principal residence is intended to be the residence that would qualify for rollover of

gain under section 1034 if it were sold. A principal residence may be a condominium or cooperative unit.[5]

A second residence of the taxpayer includes a residence used by the taxpayer as a dwelling unit during any part of the year (gain on which could qualify for rollover treatment under section 1034 if the residence were used as a principal residence). In the case of a joint return, it includes a residence used by the taxpayer or his spouse and which is owned by either or both spouses. Under the bill, up to six weeks of taxpayer use of residential property pursuant to a time-sharing arrangement for such property may qualify as a single second residence. Interest expense attributable to periods when the taxpayer (or his spouse, in the case of a joint return) is not personally using the residential property is not within the exception for residential interest.

A second residence for purposes of the interest limitation also includes a residential lot (i.e., vacant land), provided that within a reasonable time after the date the lot was acquired by the taxpayer, a residence has been constructed on the lot and the taxpayer has occupied it as a residence. To the extent the lot is subdivided and sold, however, any interest deduction claimed with respect to the subdivided land will be treated as nonbusiness interest.

Interest not treated as nonbusiness interest under the provision includes interest on debt secured by the taxpayer's stock in a housing cooperative unit that is a residence of the taxpayer, or by his proprietary lease with respect to the unit, to the extent such debt, in the aggregate, does not exceed the fair market value of the cooperative unit. In addition, interest not treated as nonbusiness interest under the provision includes the taxpayer's share under section 216 of interest expense of the housing cooperative allocable to his unit and to his share of common residential (but not commercial) areas of the cooperative.

In the case of a husband and wife filing separate returns, each spouse may deduct interest on debt secured by one residence. Alternatively the spouses may consent in writing to allow one spouse to claim interest on debt secured by two residences at least one of which is a principal residence. In the latter case, any interest of the other spouse on debt secured by a residence is treated as nonbusiness interest which may be subject to disallowance under section 163(d).

In the case of a taxpayer who owns more than two residences, the taxpayer may designate each year which residence (other than the taxpayer's principal residence) the taxpayer wishes to have treated as the second residence, the interest relating to which is not subject to limitation under the provision.

Interest subject to the limitation

Under the bill, interest subject to the limitation is all interest on debt not incurred in connection with the taxpayer's trade or business, other than debt secured by the taxpayer's residences (as described above). Thus, interest subject to limitation generally includes investment interest subject to the section 163(d) limitation

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[5] A principal residence may also include a houseboat or house trailer. See Treas. Reg. sec. 1.1034-1(c)(3).

under present law and consumer interest, such as interest paid or incurred to purchase an automobile for personal use. Also subject to the limitation under the bill is interest expense attributable to a limited business interest, including interest paid or incurred on debt of the entity in which the taxpayer has a limited business interest and interest paid or incurred to purchase or carry a limited business interest.[6] A limited business interest includes an interest as a limited partner in a partnership, an interest as a shareholder of an S corporation in whose management the taxpayer does not actively participate, as well as an interest in an enterprise as a limited entrepreneur [7] (who does not actively participate in the management of the enterprise). Interest from a limited business interest attributable to any very low income housing project (within the meaning of section 168(j)(3)(B)), a low income housing project described in section 142(c) and financed from the proceeds of tax-exempt obligations, or low income housing described in section 167(k) is not treated as investment interest by reason of the limited business interest provision.

Net investment income

Under the bill, the definition of investment income is expanded to include the taxpayer's share of income or loss (without regard to interest expense) attributable to any limited business interest (e.g., a limited partnership interest, stock of an S corporation in whose management the taxpayer does not actively participate, or any interest in other enterprises in which the taxpayer is a limited entrepreneur). It also includes the nondeductible portion of net long-term capital gain on investment property. Net investment income is increased by certain out-of-pocket expenses attributable to net leased property, as under present law.

As under present law, net investment income is the excess of investment income over investment expense. Under the bill, investment expense is determined utilizing the actual depreciation or depletion deductions allowable.

Net leases

The bill modifies the 15-percent test of present law, which determines whether leased property is subject to a net lease, and therefore constitutes a limited business interest in the hands of the lessor. Under the bill, in determining whether certain expenses constituting trade or business deductions are less than 15 percent of the rental income from the leased property, the value of the personal management and repair services performed with respect to the leased property by an individual taxpayer who is a direct owner of the property may be counted. Management and repair services of a general partner in a general partnership that directly owns the leased property may also be counted. In the case of services by the general partners, to qualify for this rule, the property must be managed exclusively by such general partners, with no

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[6] As under present law, interest on indebtedness incurred to purchase into a trade or business partnership as a general partner (which partnership interest is not a limited business interest) is not treated as nonbusiness interest for purposes of section 163(d)). See, e.g., Technical Advice Memorandum LTR 8235004 (May 21, 1982).

[7] As defined in Code sec. 464(e)(2); e.g., a grantor of a grantor trust in some circumstances.

substantial payments to third parties for management services (other than for accounting and tax preparation services and repairs). The value of legal services may not be counted.

Rental use

Under the bill, if property is used partly for rental purposes and partly for personal purposes (such as a vacation home used by the taxpayer as a residence and also rented out for part of the year), the interest on debt attributable to such property is first allocated to the rental use and the personal use under allocation rules similar to section 280A(e)(1) of present law. Interest is allocated to the rental use (rather than residential use) in the ratio of the number of days the property is rented at fair rental to the number of days the property is used during the taxable year. The interest allocated to the rental use will be allowed to the extent it does not exceed gross income (net of taxes and other deductions which would be allowed whether or not the property was used as rental property). Any interest allocable to the rental use in excess of such amount will then be treated as nonbusiness interest and will be allowed to the extent section 163(d) does not disallow the interest.

Effective Date

The interest limitation, as amended by the bill, is effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred, but is phased in over a 10-year period. The amount of interest disallowed during any year in the transitional period cannot exceed the amount which would be disallowed for that year under present law plus the applicable percentage of any additional interest which would be disallowed for that year under the new provision, if fully effective. The applicable percentage is 10 percent in 1986 and increases by 10 percent each year thereafter.

Thus, for example, in 1987 the taxpayer would calculate (1) the amount of the interest disallowed for the year under the pre-1986 rule, and then (2) the amount of interest disallowed for the year (as if fully phased in) under the post-1985 rule (as if fully phased in). Interest disallowed for 1987 would not exceed the amount calculated under (1), plus 20 percent of the amount by which (2) exceeds (1). If in any year, the amount of the interest disallowed under the new limitation (if fully phased in) would be less than the amount subject to the old limitation, the interest disallowed will be the amount determined as if the new rule were fully effective in that year. Thus, the taxpayer receives the benefit of the new rule in any year when it would give him a greater interest deduction than would the old rule.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $9 million in 1986, $62 million in 1987, $96 million in 1988, $127 million in 1989, and $127 million in 1990.

TITLE V—MINIMUM TAX PROVISIONS

Minimum Tax on Corporations and Individuals (Title V of the bill and secs. 53 and 55-59 of the Code)

Present Law

Corporate minimum tax

Under present law, corporations pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences, to the extent that the aggregate amount of these preferences exceeds the greater of the regular income tax paid or $10,000.

Tax preference items

The tax preference items included in the base for the minimum tax for corporations are:

(1) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 18 years);

(2) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion to the extent in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.[1]

For personal holding companies, accelerated depreciation on leased personal property, mining exploration and development costs, circulation expenditures, research and experimental expenditures, and excess intangible drilling costs are also preferences.

When a corporation has a regular tax net operating loss attributable to minimum tax preference items in excess of $10,000, no immediate add-on minimum tax liability is incurred with respect to those preference items. Minimum tax liability is incurred with respect to those preference items when the "preferential" portion of the net operating loss is used to offset regular taxable income, treating this portion as used only after nonpreferential net operating losses have been exhausted.

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[1] Special rules applicable to capital gains from timber have the effect of (1) exempting $20,000 of such gains from minimum tax (in addition to the general exemption of $10,000), (2) lowering the rate of minimum tax on any remaining capital gains from timber from 15 to 10 percent, and (3) providing a carryover whereby regular taxes attributable to timber income can reduce the minimum tax due in subsequent years.

Cutback in certain preferences

In addition to imposing an add-on minimum tax, present law (sec. 291) imposes a cutback in the use of certain corporate tax preferences for regular tax purposes. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference. The cutback applies, with differing percentage reductions, to the following items: (1) certain excess depletion for coal and iron ore, (2) the portion of bad debt reserves deducted by financial institutions that exceeds deductions allowable under the experience method, (3) certain interest deductions of financial institutions that are allocable to purchasing or holding certain tax-exempt obligations, (4) a foreign sales corporation's (FSC) exempt foreign trade income, (5) the reduction of recapture, under section 1250, for depreciation deductions relating to real estate, (6) for pollution control facilities, the excess of the amortization deductions allowed over the depreciation deductions that would otherwise apply, (7) intangible drilling cost deductions of integrated oil companies, and (8) the expensing of mineral exploration and development costs.

Individual minimum tax

Under present law, individuals are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the individual's regular tax owed.[2] The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount. However, the amount so determined is reduced by the foreign tax credit and the refundable credits.

Alternative minimum taxable income is generally equal to regular tax adjusted gross income, as increased by certain tax preferences and decreased by the alternative tax itemized deductions. The exemption amount, which is subtracted from alternative minimum taxable income before applying the 20 percent rate, is $40,000 for joint returns, $20,000 for married individuals filing separately, and $30,000 for single returns.

Tax preference items

The tax preference items that are added to the adjusted gross income basis for purposes of the alternative minimum tax on individuals are:

(1) Dividends excluded from gross income under section 116, which permits individuals to exclude dividends received in an amount not to exceed $100 ($200 for a joint return);

(2) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 18 years);

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[2] A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax, the investment credit recapture tax (sec. 47), the taxes applicable in some instances for annuities (sec. 72(m)(5)(B) and 72(q)), lump sum distributions from qualified pension plans (sec. 402(e)), individual retirement accounts (sec. 408(f)), and certain trust distributions (sec. 667(b)), reduced by all nonrefundable credits including the foreign tax credit.

(3) For leased personal property, the excess of accelerated depreciation over depreciation calculated under the straight-line method, with the latter being determined, in the case of property eligible for ACRS, by applying useful lives or recovery periods of five years for three-year property, eight years for five-year property, 15 years for 10-year property, and 22 years for 15-year public utility property;

(4) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(5) For mining exploration and development costs (other than those relating to an oil or gas well) that are expensed, the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period;

(6) For circulation expenditures (relating to newspapers, magazines and other periodicals) that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a three-year period;

(7) For research and experimentation expenditures that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a 10-year period;

(8) Percentage depletion to the extent in excess of the adjusted basis of the property;

(9) For net capital gains, the portion (i.e., 60 percent) deducted from gross income under section 1202, except that gain from the sale or exchange of the taxpayer's principal residence is not taken into account;

(10) For incentive stock options, the excess of the fair market value received through the exercise of an option over the exercise price; and

(11) For intangible drilling costs (relating to oil, gas, and geothermal properties) that are expensed, the amount by which the excess portion of the deduction (i.e., the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period) exceeds the amount of net oil and gas income.

For certain of these preferences, individuals can elect for regular tax purposes to take a deduction ratably over 10 years (three years in the case of circulation expenditures) and thereby to avoid treatment of the item subject to the election as a minimum tax preference. The preferences, in addition to circulation expenditures, with respect to which such an election can be made are research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. In addition, the ACRS provisions themselves allow certain similar elections.[3] In

[3] Moreover, in the case of intangible drilling costs, a taxpayer (other than a limited partner or a passive subchapter S shareholder) may elect to forego the expense deduction and claim five-year ACRS and the investment tax credit instead. A taxpayer making this election would not be subject to the minimum tax on these items.

general, a principal reason for making such an election is to preserve for later years the value of an otherwise preferential deduction which would not benefit the taxpayer in the year when the election is made, because the taxpayer would be subject to the alternative minimum tax.

Alternative tax itemized deductions

Certain of the itemized deductions allowable in calculating regular taxable income are allowable as well for purposes of calculating alternative minimum taxable income. The alternative tax itemized deductions are:

(1) Casualty or theft losses, and gambling losses to the extent not in excess of gambling gains;

(2) Charitable deductions, to the extent allowable for regular tax purposes;

(3) Medical deductions, to the extent in excess of 10 percent of adjusted gross income;

(4) Qualified interest expenses, which are limited to (a) qualified housing interest (i.e., interest incurred to acquire, construct, or rehabilitate a primary residence or other qualified dwelling used by the taxpayer), plus (b) other interest expenses deducted by the taxpayer, but only to the extent not in excess of qualified net investment income for the year;[4] and

(5) Deductions for estate tax attributable to income in respect of a decedent.

Other regular tax itemized deductions, such as those for state and local taxes paid and for certain investment expenses, are not allowed for minimum tax purposes.

Credits and NOLs

In calculating minimum tax liability, no nonrefundable credits are allowed except for the foreign tax credit. The limitation on the foreign tax credit applying for regular tax purposes (which, in general, prevents use of the credit to offset a greater percentage of one's tax liability than the percentage of taxable income that is foreign source income) applies for minimum tax purposes as well, but is recalculated to reflect the percentage of minimum taxable income that comes from foreign sources. Credits that do not benefit the taxpayer because of the imposition of minimum tax liability can be carried back or forward to other taxable years.

Individuals with net operating losses are allowed to deduct such losses against alternative minimum taxable income. However, for years beginning after 1982 the losses are computed, for minimum tax purposes, by reducing the regular tax net operating losses by the amount of the items of tax preference.

Reasons for Change

The committee believes that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial

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[4] Since this limitation applies only to itemized deductions for interest expenses, it generally has no effect on interest deductions that are claimed "above-the-line," such as business interest and interest attributable to the production of rents and royalties. Interest to carry limited partnership interests and S corporation stock is treated as an itemized deduction, however.

economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, the committee believes that it is inherently unfair for high-income taxpayers to pay little or no tax due to their ability to utilize tax preferences.

With respect to the taxation of individuals, fairness and taxpayer morale have been particularly harmed by the proliferation of tax shelters, whereby individuals with substantial economic incomes in effect purchase tax benefits that are not accompanied by significant economic burdens, and thereby may escape significant tax liability. Although some tax shelters depend upon the availability of tax preferences, many tax shelters exploit inherent structural features of the tax system (e.g., the contrast between allowing current depreciation and interest deductions, on the one hand, and not taxing unrealized appreciation, on the other). An effective minimum tax is necessary to allow the committee to substantially reduce the marginal tax rates applicable to high-income taxpayers without causing an overall percentage tax reduction for this group larger than for the average taxpayer.

In the case of a passive investor in a business activity, the committee believes that losses by the activity are not truly realized by the investor prior to disposition of his or her interest in the activity. Under present law, in the case of a C corporation, losses and expenses borne by the corporation, and any decline in the value of the corporation's stock, do not give rise to the recognition of any loss on the part of shareholders prior to their disposition of the stock. Moreover, even a loss upon disposition is not recognized for regular tax purposes to the extent that it causes the taxpayer to have a net capital loss for the year in excess of $3,000.[5] For reasons similar to those applying in the C corporation context, as well as concern about tax shelters, the committee believes that it is important to deny the use of certain losses from passive activities to shelter unrelated income for minimum tax purposes.

With respect to the taxation of corporations, both the perception and the reality of fairness have been harmed by instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders. Even to the extent that these instances reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes that they demonstrate a need for change.

The committee believes that the minimum taxes under present law do not adequately address the problem, principally for two reasons. First, the corporate minimum tax, as an add-on rather than an alternative tax, is not presently designed to define a comprehensive income base. Second, the present minimum taxes do not sufficiently approach the measurement of economic income. By leaving

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[5] Code section 1211(b).

out many important tax preferences, or defining preferences overly narrowly, the individual and corporate minimum taxes permit some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all liability.

Certain of the tax preferences under present law apply only to individuals, or only to individuals and personal holding companies. The committee believes that, in general, preference items should apply both to individuals and corporations, except in the case of items that do not apply to both for regular tax purposes.

With regard to the preference relating to the expensing of research and experimentation expenditures, however, the committee believes that, for incentive reasons, corporations, including personal holding companies, should not be required to treat such expensing as a preference. At the same time, the committee believes that such expensing should continue to be treated as a preference for individuals, because of the use of such expensing in tax shelters.

With respect to certain items that constitute tax preferences, at least for some taxpayers, under present law, the committee believes that modifications of the definitions of the preferences are needed. In the case of accelerated depreciation on real and personal property, the committee believes that present law fails to account for the fact that the useful lives of items of real and personal property generally are longer than the useful lives applying for minimum tax purposes. With respect to intangible drilling costs, the committee believes that taxpayers should not be permitted to use the preference to offset all net oil and gas income before being required to include it in the minimum tax base.

With respect to capital gains, the committee believes that the amount of the net capital gain deduction treated as a preference requires modification in two respects. First, the tax rate effectively applying to such gains under the minimum tax should not exceed the rate effectively applying under the regular tax (under which, for individuals, a portion of such gains is deducted but the remaining portion is taxed at the regular tax rate). Second, in the case of certain insolvent farmers who realize capital gain in the course of liquidating their holdings to satisfy indebtedness, minimum tax liability should be restricted during the present farming crisis.

In addition, the committee believes that certain items, not presently treated as preferences, must be added to the minimum tax base if the minimum tax is to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax. The items as to which the committee has reached this determination include tax-exempt interest on newly issued nongovernmental obligations, excludable income earned abroad by U.S. citizens, use of the completed contract method of accounting, excludable foreign sales corporation (FSC) income, and a portion of the untaxed appreciation relating to charitable contributions of appreciated property. In addition, for the reasons discussed above, the committee believes that certain passive farming losses and net losses relating to passive investment activities, commonly reflecting the use of tax shelters by individuals with substantial incomes in order to avoid tax liability, should be disallowed for minimum tax purposes.

Finally, the committee believes that the present law structure of the alternative minimum tax requires modification in certain re-

spects. In particular, to the extent that tax preferences reflect deferral, rather than permanent avoidance, of tax liability, some adjustment is required with respect to years after the taxpayer has been required to treat an item as a minimum tax preference, and potentially to incur minimum tax liability with respect to the item. Absent such an adjustment, taxpayers could lose the benefit of certain deductions altogether.

Explanation of Provisions

1. Overview

The bill repeals the present law add-on minimum tax for corporations beginning in 1986, creates a new alternative minimum tax on corporations, and expands the alternative minimum tax on individuals.

Corporations.—Generally, the tax base for the alternative minimum tax on corporations is the taxpayer's regular taxable income, increased by the taxpayer's tax preferences for the year and adjusted by computing certain deductions in a special manner which negates the acceleration of such deductions under the regular tax. The resulting amount, called alternative minimum taxable income, then is reduced by a $40,000 exemption and is subject to tax at a 25-percent rate. The amount so determined may then be offset by the minimum tax foreign tax credit to determine a "tentative minimum tax." These rules are designed to ensure that, in each taxable year, the taxpayer must pay tax equalling at least 25 percent of an amount more nearly approximating its economic income (above the exemption amount).

The net minimum tax, or amount of minimum tax due, is the amount by which the tax computed under this system (the tentative minimum tax) exceeds the taxpayer's regular tax. Although the minimum tax is, in effect, a true alternative tax, in the sense that it is paid only when it exceeds the regular tax, technically the taxpayer's regular tax continues to be imposed, and the net minimum tax is added on.

Individuals.—The structure for the alternative minimum tax on individuals generally is the same as under present law, except that certain deferral preferences (such as incentive depreciation) give rise to adjustments to the minimum tax base over a period of years, in order properly to compute total income each year in light of the fact that, in later years, the regular tax deduction typically is smaller than the deduction would be if calculated on a straight line basis over a longer period. The alternative minimum tax on individuals differs from that applying to corporations in several respects. For example, there are some differences between the preferences applying to individuals and those applying to corporations, and certain itemized deductions that individuals can claim for regular tax purposes are not allowable under the minimum tax.

Minimum tax credit.—When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) is allowed as a credit against the regular tax liability of the taxpayer in subsequent years. However, this credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years. For individuals, the minimum

tax credit applies only to minimum tax liability incurred due to deferral preferences (such as depreciation), i.e., preferences for which the timing, rather than the amount, of a deduction gives rise to its treatment as a tax preference.

Normative elections.—Taxpayers may elect to have the minimum tax treatment of certain expenditures apply for regular tax purposes. When an election is made, no preference is added or treated as an adjustment for minimum tax purposes.

Incentive credits.—Nonrefundable credits (such as the general business credit) generally cannot be used to reduce regular tax liability to less than the tentative minimum tax. Credits that cannot be used by the taxpayer due to the effect of the alternative minimum tax can be carried over to other taxable years under the rules generally applying to credit carryovers. In order to provide transition relief, certain corporations that have recently experienced losses are permitted to use credits arising with respect to the period prior to the effective date of the bill to offset certain minimum tax liability.

2. Preferences and adjustments applying to both individuals and corporations

Depreciation

Incentive depreciation on real and personal property placed in service after 1985, to the extent in excess of nonincentive depreciation, is treated as a preference. The amount of the preference is calculated, with respect to such new property, by making adjustments similar to the types of adjustments that are made in determining the depreciation allowable with respect to earnings and profits. That is, instead of making preference adjustments with respect to specific items of property in the amount by which the regular tax deduction exceeds the normative deduction, the nonincentive depreciation deduction is substituted for the regular tax incentive depreciation deduction for all property placed in service after 1985. The principal effect of this system is that it permits "netting", i.e. to the extent that a nonincentive deduction relating to an item of property exceeds an incentive deduction, the amount of the preference is reduced.[6]

Consider, as an example that does not reflect the actual details of the incentive and nonincentive depreciation systems the case of a taxpayer who was permitted fully to deduct a $10 expense in the year that the property to which the expense related was placed in service, but who was required to write off the expense over two years for purposes of the nonincentive depreciation system. For that taxpayer, assuming there were no other differences between the taxpayer's regular and minimum taxable income, regular taxable income would be $5 less than minimum taxable income for the year in which the property was placed in service. In the following taxable year, however, the taxpayer's regular taxable income would be $5 greater than minimum taxable income (because no fur-

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[6] Nonincentive deductions typically exceed incentive deductions in the later years of the useful life of an item of property for which incentive depreciation is allowed; i.e., at such time the regular tax deduction typically is understated because it has been overstated in prior taxable years.

ther regular tax deduction would remain with respect to the property, whereas the taxpayer would still be entitled to write off the last $5 of basis under the nonincentive system). If the taxpayer also had a separate preference in the amount of $5 in the second year, the taxpayer's regular and minimum taxable incomes would be equivalent in that year (whether or not that second item related to depreciation).

Accelerated depreciation with respect to property placed in service prior to 1986 is treated as a preference only to the extent that it constitutes a preference under present law. Thus, for example, for pre-1986 personal property, accelerated depreciation is a corporate tax preference only in the case of leased personal property in the hands of a personal holding company. In addition, present law rules apply to the measurement of depreciation preferences relating to pre-1986 property. Thus, for example, present law rules for measuring the amount of accelerated depreciation that constitutes a preference continue to apply to pre-1986 property, and preferences relating to such property continue to be measured on an item-by-item basis, rather than under the netting system described above.[7]

For property placed in service after 1985, nonincentive depreciation generally is defined as straight-line depreciation over the ADR midpoint life of the property (forty years in the case of real estate other than low income housing). A similar depreciation system presently is used and will continue to be used with respect to property leased by a taxable entity to a tax-exempt entity. Under the bill, a nonincentive system of depreciation applies for certain other purposes as well (including the measurement of depreciation for determining earnings and profits and with respect to property placed in service outside of the United States). Since taxpayers can elect to use this depreciation system for regular tax purposes, no minimum tax adjustment to income is made to the extent that any such election applies. (A complete description of the nonincentive depreciation system is described in the portion of the report describing the new depreciation system.)

As an exception to the above rule, no adjustment is made for minimum tax purposes with respect to certain property described in paragraph (2), (3), (4) or (5) of section 168(f) (e.g., property depreciated under the income forecast method, etc.) In the case of rehabilitation of low-income housing amortized under section 167(k) and placed in service after 1985, the general rules for post-1985 property apply, except that such property is treated as having a useful life of fifteen years for minimum tax purposes.

For all depreciable property to which minimum tax adjustments apply, adjusted basis is determined for minimum tax purposes with reference to the amount of depreciation claimed for minimum tax purposes under the nonincentive system. Thus, the amount of gain on the disposition of such property will differ for regular and minimum tax purposes.

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[7] As a transition rule, certain specified utility property constructed, reconstructed, or acquired pursuant to a written contract which was binding on December 31, 1980, is treated as property placed in service prior to 1986.

For certain real property placed in service before January 1, 1986, and for which accelerated depreciation or amortization is allowed but treated as a preference under present law (e.g., a certified pollution control facility), the present law preference continues to apply for the duration of the property's useful life. The rapid amortization rule for certified pollution control facilities is repealed by the bill with respect to property placed in service after December 31, 1985.

Mining exploration and development costs

Mining exploration and development costs, incurred after 1985, that are expensed (or amortized under section 291) for regular tax purposes are required to be recovered through ten-year straight line amortization for purposes of the alternative minimum tax. As with depreciation, the minimum tax treatment of mining exploration and development costs involves a separate calculation for all items of income and expense relating to such costs. Thus, for example, in the case of a noncorporate taxpayer who incurred a one-time mining exploration and development expense in the amount of $100, the regular tax deduction would be $100 in the year when the expenditure was incurred, and the minimum tax deduction would be $10 for each of the ten years beginning in the year when the expenditure was incurred. The basis of property with respect to which such costs were incurred, and the amount of gain or loss upon disposition, likewise may differ for regular and minimum tax purposes, respectively.

Under this approach, any mining exploration and development costs which are included in regular taxable income when the mine reaches the producing stage are not included in minimum taxable income. In addition, when a loss is sustained with respect to a mining property (e.g., the mine is abandoned as worthless, giving rise to a loss under section 165), the taxpayer is permitted to deduct, for minimum tax purposes, all mining exploration and development costs relating to that property that have been amortized and not yet written off under the minimum tax.

Use of completed contract method of accounting

In the case of any long-term contract entered into by the taxpayer after September 25, 1985, use of the completed contract method of accounting is not permitted for purposes of the minimum tax. Instead, the taxpayer is required to apply the percentage of completion method in determining minimum taxable income relating to that contract. As with depreciation and mining exploration and development costs, this preference is calculated, not by adding an amount to regular taxable income, but by substituting the minimum tax treatment for the regular tax treatment with respect to all items arising with respect to a contract to which the preference relates. Of course, this preference applies only to contracts excepted under the bill from use of the percentage of completion method for regular tax purposes.

Percentage depletion

As under present law, the excess of the regular tax deduction allowable for depletion over the adjusted basis of the property at the

end of the taxable year (determined without regard to the depletion deduction for the taxable year) is treated as a preference. Thus, for example, a taxpayer who claimed a deduction for percentage depletion in the amount of $50, with respect to property having a basis (disregarding this deduction) of $10, would have a minimum tax preference in the amount of $40.

Intangible drilling costs

The preference for intangible drilling costs is generally the same as the present law preference for individuals, except that 65 percent, rather than 100 percent, of net oil and gas income may offset the preference. Thus, the amount of excess intangible drilling costs is treated as a preference to the extent that it exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties. Net oil and gas income is determined without regard to deductions for excess intangible drilling costs. Under this rule, for example, a taxpayer with $100 of net oil and gas income (disregarding excess intangible drilling costs) and $80 of excess intangible drilling costs would be required to treat such costs as a preference in the amount of $15 ($80 excess IDC less $65 net income offset).

The amount of excess intangible drilling costs is defined as the amount of the excess, if any, of the taxpayer's regular tax deduction for such costs (deductible under either section 263 (c) or (i) or 291) over the normative deduction, i.e., the amount that would have been allowable if the taxpayer had amortized the costs over ten years on a straight-line basis or through cost depletion. The preference does not apply to costs incurred with respect to a nonproductive well.

In applying the preference for intangible drilling costs, a taxpayer's property (as under present law for individuals) is divided into two parts: properties that are geothermal deposits, and all other properties with respect to which intangible drilling costs are incurred. This separation applies for all purposes under the minimum tax. Consider, for example, the case of a taxpayer who has (1) oil wells with net oil and gas income of $100 and excess intangible drilling costs of $80, and (2) geothermal deposits with net income of $100 and excess intangible drilling costs of $40. This taxpayer has a preference in the amount of $15 with respect to the oil wells, and no preference with respect to the geothermal deposits.

With respect to intangible drilling costs for any well, the taxpayer may elect the use of any method which would be permitted for purposes of determining cost depletion with respect to such well. To be effective, such an election must be made at such time and in such manner as prescribed by the Secretary in regulations. Once made, such an election applies, with respect to the costs subject to it, for all regular and minimum tax purposes. Thus, costs recovered under this method are not treated as a minimum tax preference.

In the case of a disposition of any oil, gas, or geothermal property to which section 1254 generally would apply, or of any mining property to which section 616(c) generally would apply, if the taxpayer makes an election as described above (or to the extent of a normative election, as described below), amounts deducted pursuant to the election are treated as deducted for purposes of section 1254 or section 616(c), as the case may be.

Tax-exempt interest on nonessential function bonds

Interest on certain tax-exempt bonds issued after December 31, 1985 is treated as a preference. This rule applies only with respect to nonessential function bonds, the interest on which is exempt from taxation under section 103. In general, nonessential function bonds are those bonds that are subject to the unified volume limitation in new Code section 145.

For purposes of this rule, interest on current refundings of bonds issued before 1986 is not a preference item if the current refunding bonds are not subject to the new unified volume limitation. (*See* new Code section 145(k)). Interest on bonds issued after 1985, which bonds either (1) are exempt from the new volume limitation because of transitional exceptions in the bill (*see* bill sec. 703), or (2) are subject to the limitation as advance refundings allowed under a transitional exception (*see* bill sec. 703(o)) is treated as a preference item. Finally, the fact that a portion of an essential function bond is subject to the unified volume limitation (*see* new Code sec. 141(a)(3)) does not result in treatment of interest on that bond as a preference item.

In the case of a taxpayer who is required to include in minimum taxable income any interest that is tax-exempt for regular tax purposes, section 265 (denying deductions for expenses and interest relating to tax-exempt income) does not apply, to the extent of such inclusion, for purposes of the minimum tax. Thus, for example, a taxpayer who incurs interest expense with respect to purchasing or carrying a nonessential function bond issued after 1986, and who is denied a deduction with respect to such expense for regular tax purposes under section 265, is allowed the deduction for minimum tax purposes.

Charitable contributions of appreciated property

In the case of a taxpayer who makes one or more charitable contributions of appreciated capital gain property, an amount equal to a portion of the regular tax deduction claimed with respect to such appreciation (whether or not such deduction is an itemized deduction or is claimed by an individual) is treated as a minimum tax preference. For purposes of this rule, capital gain property has the same meaning as under the rules relating to charitable deductions.

In determining the amount of the preference, several limitations apply. First, the taxpayer calculates the amount by which the charitable deduction would have been reduced had all capital gain property been taken into account, for purposes of the regular tax charitable deduction, at its adjusted basis. In other words, unrealized gain on appreciated property is offset by unrealized loss on property that is worth less than its adjusted basis.[8]

Second, the amount of the preference is determined by disregarding any amount that is carried forward to another taxable year for purposes of the regular tax. Thus, when a portion of a charitable deduction is carried forward because it exceeds the applicable per-

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[8] Ordinarily, of course, a taxpayer would not make a charitable contribution with respect to capital gain property that is worth less than its adjusted basis. Rather, the taxpayer would generally be expected to sell the property, deduct the loss, and then donate the sale proceeds to the charitable organization and claim a charitable deduction.

centage limitation on such contributions, the portion so carried forward cannot increase the amount of the minimum tax preference until it is allowed as a deduction for regular tax purposes.

Third, the amount of unrealized appreciation that is treated as a preference cannot exceed the net amount of the taxpayer's other preferences (including amounts computed as adjustments). This calculation is made by comparing the taxpayer's regular taxable income with the taxpayer's alternative minimum taxable income (but treating the charitable deduction as fully allowed for minimum tax purposes). For purposes of this comparison, the regular tax standard deduction (in the case of a non-itemizer), and the regular tax personal exemptions are disregarded.[9]

Exempt income of FSCs and DISCs

In the case of a foreign sales corporation (FSC), any exempt foreign trade income (as defined by section 923(a)) is, in effect, treated as a preference for shareholders. Specifically, all FSC income and deductions are treated as allocable to shareholders, on a pro rata basis, for minimum tax purposes. In addition, any regular tax paid by the FSC is treated allocably as regular tax paid by the shareholders for purposes of determining the amount of net minimum tax. Moreover, for minimum tax purposes (including determination of the amount of the alternative minimum tax foreign tax credit), the income is treated as effectively connected with a trade or business conducted through a permanent establishment within the United States and derived from sources within the United States. In light of this preference, the alternative minimum tax does not apply to a FSC itself (as opposed to its shareholders). Similar rules apply with respect to domestic international sales corporations (DISCs).

3. Additional preferences (other than limitations on itemized deductions) applying to individuals

Circulation expenditures

An individual who incurs circulation expenditures described in section 173 is not permitted to expense (his or her) post-1985 expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1985 expenditures ratably over a three-year period. However, if the taxpayer realizes a loss with respect to property to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction. These rules apply to personal holding companies as well as to individuals.

For example, an individual who incurred such expenditures in the amount of $30 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred, and would claim alternative minimum tax deductions of $10 for that year and the two succeeding taxable years. However, if the newspaper to which the expenditures related ceased operations in

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[9] It is also intended that alternative minimum taxable income, for this purpose, will be calculated by allowing all itemized deductions allowable in computing the regular tax.

the second year, the entire $20 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Research and experimental expenditures

An individual who incurs research and experimental expenditures described in section 174 is not permitted to expense the expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1985 expenditures over a ten-year period. As with certain other items (such as depreciation and mining exploration and development costs), this treatment applies for all minimum tax purposes, rather than as an annual adjustment to regular taxable income. If the taxpayer abandons a specific project to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction.

For example, an individual who incurred research and experimental expenditures in the amount of $100 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred (absent a section 174(b) election), and would claim alternative minimum tax deductions of $10 for that year and the nine succeeding taxable years. However, if the taxpayer abandoned the specific project to which the expenditures related in the second year, the entire $90 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Net capital gain deductions

General rule

For individuals, the net capital gain deduction (under section 1202) continues to be treated as a preference.[10] However, the preference for capital gains is reduced by 3/25 of the net gain, i.e., the portion necessary to ensure that, as under present law, individuals at the top marginal rate will not be subject to a higher rate of tax on capital gains under the minimum tax than under the regular tax.

For example, a taxpayer with $100 of net capital gains realized in 1986 would be permitted a regular tax capital gain deduction of $50. The portion not so deducted would be taxed at a maximum rate of 44 percent (under the blended rates that apply for 1986 under the bill.) Thus, the taxpayer's regular tax on the gain (assuming application of the maximum rate) would be $22. Under the alternative minimum tax, the preference would be reduced by 3/25 of the gain. The portion included in the minimum tax base would be subject to tax at a 25 percent rate, leading to alternative minimum tax liability of $22.

In determining the amount of the net capital gain preference, taxable gain from the sale or exchange of a principal residence, as defined in section 1034, is not taken into account.

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[10] Under the bill, capital gains realized by corporations are taxed at the same rate as ordinary income, i.e., without any deduction of net gains or application of a lower rate.

Exception for transfers by insolvent farmers

An exception to the general rule applies in the case of certain transfers by insolvent farmers. Under this exception, when the requirements for its applicability are satisfied, an insolvent taxpayer who transfers land used in the conduct of the trade or business of farming in satisfaction of indebtedness is not required to treat certain capital gain, deducted from income for regular tax purposes under section 1202, as a minimum tax preference.

The exception applies only to transfers by an individual more than 50 percent of whose gross receipts over the prior three years were derived from farming. Gross receipts from the prior three years are aggregated for purposes of this determination; thus, it is not necessary for the individual to have derived more than 50 percent of his or her gross receipts from farming during each of the prior three years.

For the exception to apply to a transfer, substantially all of the proceeds of the transfer (other than ordinary and necessary expenses of making the transfer, such as a sales commission paid to an unrelated third party) must be applied in satisfaction of indebtedness of the taxpayer. The exception does not apply to a transfer that is made to a member of the taxpayer's family (as defined in section 453(f)(1)).

Moreover, the exception does not apply unless, during the taxable year, the taxpayer disposed of 90 percent or more of the land used in the trade or business of farming that the taxpayer owned at the beginning of the taxable year. This determination is made by comparing the fair market value of the farmland held by the taxpayer at the beginning and at the end of the taxable year, respectively. Thus, for example, if the taxpayer disposes of all the farmland that he or she held at the beginning of the year, but acquires new farmland having half the value of his or her holdings at the beginning of the year, the dispositions are not covered by the exception.

The exception does not apply to a transfer unless the taxpayer is insolvent immediately prior to the transfer. However, a transfer which is made during the taxable year but before the taxpayer becomes insolvent can count towards satisfaction of the requirement that the taxpayer dispose of 90 percent of his or her farmland during the taxable year. The determination of whether a taxpayer is insolvent is made under the standard set forth in section 108(d)(3), which provides that "the term 'insolvent' means the excess of liabilities over the fair market value of assets."

The exception for certain farm sales applies to taxable years beginning after December 31, 1984, and before January 1, 1989.

Incentive stock options

As under present law, in the case of a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A), the amount by which the fair market value of the share at the time of the exercise exceeds the option price is treated as a preference. For purposes of this rule, the fair market value of a share is determined without regard to any restrictions other than one which, by its terms, will never lapse.

Foreign earned income exclusion

Any amount excluded from the gross income of an individual under section 911(a)(1) (relating to foreign earned income of a U.S. citizen or resident living abroad) is treated as an alternative minimum tax preference. However, deductions and foreign taxes paid with respect to such income can be taken into account in determining the amount of alternative minimum tax liability.[11] Amounts excluded under section 911(a)(2) (relating to housing costs of an individual who qualifies for the exclusion of foreign earned income) do not give rise to any preference or other adjustments under the minimum tax.

Excess farm losses

Any excess farm loss of an individual, to the extent not already denied for minimum tax purposes under the preferences described above, is treated as a preference. An excess farm loss is defined as the excess of the taxpayer's loss for the taxable year from any tax shelter farming activity over twice the taxpayer's cash basis in such activity as of the close of the taxable year.

For purposes of this provision, the term "tax shelter farm activity" means (1) a farming syndicate (as defined in section 464(c), as modified by section 461(i)(4)(A)), and (2) any other activity consisting of farming unless the taxpayer materially participates in the activity. A taxpayer is treated as materially participating in the activity if a member of the taxpayer's family (within the meaning of section 2032A(e)(2)) so participates, or if the taxpayer meets the requirements of paragraph (4) or (5) of section 2032A(b) (relating to certain retired or disabled individuals and surviving spouses.)

The determination of whether an individual has materially participated in a farming activity is made under a standard similar to that set forth in Treasury Regulation section 20.2032A-3(e). Thus, for example, employment of an individual on a full-time basis in the operation of a farm, or performance by the individual of all necessary functions in operating the farm, both may constitute material participation.

An individual also may materially participate in a farming operation when his or her actual activities are on other than a full-time basis or when the individual personally does not perform all necessary functions in operating the farm. In this connection, the fact that the individual utilizes employees or contract services to accomplish day-to-day functions of the business does not preclude a finding that he or she has materially participated in the farming activity.

When an individual's activities with respect to a farming operation are not on a full-time basis, or the individual utilizes employees or contract services to accomplish day-to-day functions of the business, no single factor is determinative of whether the individual materially participates in the farming operation. However, physical work and participation in management decisions are two principal factors to be considered. In order to be treated as materi-

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[11] For regular tax purposes, such deductions and taxes paid cannot be taken into account, under section 911(d)(6), concerning the denial of double tax benefits with respect to amounts excluded from gross income under section 911

ally participating due to the latter factor, such an individual must participate in the financial and management decisions of the farming operation by regularly advising or consulting with other managing parties with respect to management decisions and by regularly overseeing production activities of the farming operation.

A limited partner (as defined under applicable State law) is treated as not materially participating, or providing substantial personal services, with respect to the activity. Thus, unless such person is also a general partner, there is, in effect, a conclusive presumption that the person has not materially participated in the activity.

The amount of a taxpayer's cash basis in a tax shelter farm activity is determined by making adjustments to the taxpayer's adjusted basis, in the case of an interest in a partnership. In the case of an interest in an activity other than a partnership, the same adjustments are made, to an amount determined by applying the same principles that are used to determine the adjusted basis of a partnership interest.

The principal difference between the definitions of cash basis in a tax shelter farm activity and of adjusted basis in a partnership, respectively, is that, for purposes of cash basis, certain financing is disregarded.

First, liabilities of the partnership are not included in cash basis. Second, cash basis does not include any amount borrowed by the partner pursuant to a transaction arranged by the partnership or by any person who participated in the organization, sale, or management of the partnership (or any person related to such person within the meaning of section 461(i)(2)(C)(ii)(I)). By contrast, an amount borrowed by the partner using true third party financing (e.g., an arm's length arrangement with a commercial lender that is not a participant in the partnership activity) can, under appropriate circumstances, be included in cash basis.

Third, cash basis does not include any amount that is secured by any assets used in the activity (or, in the case of a partnership, any asset of the partnership). For purposes of this rule, the fact that, in the event of default by a partner, a lender may be able to levy with respect to any property owned by the partner (including the partner's interest in partnership property) is not inconsistent with this rule, so long as the lender possesses no secured interest with respect to the partnership property.

In determining the amount of a taxpayer's cash basis in a tax shelter farm activity, an amount will not be included solely because the taxpayer nominally transfers it to the activity. For example, a partner's cash basis in a partnership would not be increased solely because he or she transferred $100,000 from his or her personal bank account to the partnership's bank account. An amount can be included in cash basis only to the extent that it is invested in property used in the farming activity, or is otherwise reasonably expected to be used in the business (e.g., to pay ongoing expenses such as compensation to employees).

The amount of a taxpayer's cash basis (as well as the amount of an allowable farm loss) is also adjusted, for minimum tax purposes, to reflect the application of the excess farm loss rule in prior taxable years. These adjustments are made using rules similar to those applying for regular tax purposes under the at risk rules, as

set forth in Code sections 465(b)(5) (concerning reduction of the amount at risk to reflect losses allowed as deductions) and 465(e) (concerning the recapture of losses where the taxpayer's amount at risk is less than zero).[12]

As a transition rule, cash basis is treated as not less than zero as of the beginning of the taxable year beginning in 1986 for any activity. In addition, there will be no recapture with respect to losses arising in taxable years prior to 1986 (e.g., in the event of a cash withdrawal from the activity).

Once the amount of a taxpayer's cash basis with respect to an activity is determined, deductions allocable to the activity, to the extent in excess of gross income allocable to the activity, are disallowed, for minimum tax purposes, to the extent that such excess exceeds twice the taxpayer's cash basis in the activity. In applying this limitation to proprietorships, the taxpayer's activity with respect to each farm is treated as a separate activity.

The amount of the deductions allocable to an activity is determined after taking account of all preferences and making all adjustments required for the determination of alternative minimum taxable income, other than the preference for excess passive activity losses. In other words, no deduction which is treated as a minimum tax preference, or which is redetermined (as with depreciation) for minimum tax purposes, is "double-counted" by also being considered in the determination of excess farm losses.

Consider, for example, a taxpayer who, with respect to a tax shelter farm activity, had a cash basis (as of the end of the year, without regard to income or loss for the year) of $10, gross income for the year of $15, and an incentive depreciation deduction in the amount of $60 (but no other deductions), which was redetermined to equal $40 under the nonincentive depreciation system applying for minimum tax purposes. With respect to depreciation, the taxpayer's alternative minimum taxable income would be $20 greater than his regular taxable income ($60 minus $40). The amount of the taxpayer's excess farm loss would equal $5 (a loss of $25, or $40 minus $15, which would constitute a preference only to the extent in excess of twice the taxpayer's $10 cash basis). As of the beginning of the following taxable year, the taxpayer's cash basis in the activity, for purposes of the excess farm loss rule, would be zero. If, in such year, the taxpayer withdrew $2 from the activity, $4 losses of previously deducted for minimum tax purposes would be recaptured under the rule for minimum tax purposes.

To the extent that a loss from an activity constitutes a preference under the excess farm loss rule, the amount is treated, for minimum tax purposes, as a farm loss incurred in the same activity in the succeeding taxable year. Thus, it will be allowed as a minimum tax deduction in the succeeding year, to the extent that the taxpayer does not again have an excess farm loss in such year (determined in light of cash basis for that year along with other income and deductions relating to the same farming activity for such year).

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[12] Thus, for example, a taxpayer with cash basis in an activity of $100,000, and losses in the amount of $160,000, would reduce cash basis by half of the amount of such losses (in light of the two-to-one ratio of allowable losses to cash basis), or to $20,000.

In defining an excess farm loss for purposes of this rule, no account is taken of any loss resulting from a disposition of part or all of any interest of the taxpayer in the activity. Thus, for example, a taxpayer who sold his or her limited partnership interest in a farming syndicate at a loss would not be denied any of that loss under this rule. In the case of a disposition of a taxpayer's entire interest in an activity, any losses relating to that activity that have in effect been suspended (i.e., treated as preferences but not allowed in a subsequent taxable year) under the excess farm loss rule are allowed in full, without being treated as a preference, for minimum tax purposes.

The reason for this exception is that the committee intends that the excess farm loss rule serve, in effect, to require that certain losses be realized in a meaningful economic sense before being recognized for minimum tax purposes. For example, even to the extent of nonincentive depreciation of the assets of a tax shelter farm activity, no loss is considered to have been realized by a passive investor, at least to the extent in excess of cash basis, until the investor actually makes an additional cash contribution.[13] Similarly, if a C corporation realizes losses that diminish the value of corporate stock, no deduction is allowed to shareholders prior to the disposition of stock. However, this rationale no longer applies once a taxpayer disposes of an interest in an activity, and thus has finally realized all gain or loss relating to that interest.

In light of the purpose for the exception to the excess farm loss rule applying to dispositions, this exception does not apply with respect to dispositions in form only. Thus, if a disposition, when considered in combination with any related transaction, does not change significantly the substance of the taxpayer's economic interest in the activity, it is not excepted from the excess farm loss rule. For example, losses realized from churning transactions and sales to related parties (e.g., a sale of an interest in an activity to a party that, in a related transaction, sells a similar interest to the taxpayer) may be subject to the excess farm loss rule, where appropriate in light of the purpose of the exception for dispositions.

Excess passive activity losses

Any excess passive activity loss of an individual, to the extent not already denied for minimum tax purposes under the preferences described above (including the excess farm loss rule), is treated as a preference. An excess passive activity loss is defined as an amount equal to the amount by which the aggregate losses for the taxable year from all passive activities exceeds the aggregate income for such activities for the year. However, in determining the amount of the preference, this amount is reduced by certain cash basis of the taxpayer in passive investment activities.

The committee believes that this preference should apply because, when an individual's relation to an activity is that of a passive investor, any loss realized by the activity is not truly realized by such individual prior to disposition of his or her interest in the activity. Moreover, the effort to measure, on an annual basis, real

[13] Losses are denied under this rule only to the extent in excess of twice the taxpayer's cash basis in order to lessen the adverse impact of the rule on taxpayers.

economic losses from passive activities gives rise to distortions in light of the potential for underlying appreciation of assets the taxation of which is deferred, as well as the failure to measure precisely all items which may mismatch tax deductions and economic income. The latter problem is particularly acute with respect to leveraged transactions. Only when a taxpayer disposes of his or her interest in an activity is it possible to determine whether or not a loss was sustained over the entire time that he or she held the interest.

For similar reasons, under present law, an individual who owns stock in a C corporation receives no deduction with respect to expenses incurred by the corporation, or for any decline in the value of its stock, prior to a taxable disposition of the stock. The committee believes that this rule is appropriate with respect to passive investments even when they are not conducted using the vehicle of a C corporation. Thus, the committee believes that, for passive investments as for stock in a C corporation, losses should be subject to some limitation, but with the exception that a loss sustained upon disposition of a passive investment interest (to the extent not previously allowed for minimum tax purposes), will be allowed without being treated as a preference in computing minimum tax liability for the year of disposition.

The passive loss preference generally is intended to separate from other business activities (e.g., earning a salary or operating one's own business) those investments in which the taxpayer is not involved in the underlying business. The type of activity to which the preference is meant to apply commonly involves investing in a limited partnership, grantor trust, or S corporation, or serving as a "silent" partner in a general partnership where the taxpayer's involvement is limited to financing the enterprise. Agency relationships, where the taxpayer's affairs are managed by an agent without taxpayer involvement in the underlying business, are also a common type of passive investment within the intended scope of the preference. However, where the taxpayer holds an interest in business property directly, the fact that an agent may be employed, for example, to collect rents, should not cause the activity to be classified as passive where the taxpayer actively oversees the activity and participates in decisionmaking.

In general, an activity qualifies as a passive activity if a substantial portion of the income from such activity is from a trade or business. For this purpose, all rents and royalties are considered income from a trade or business. However, income such as dividends, interest, and gains from the disposition of assets not held for the production of business income (as so defined) are generally not considered income from a trade or business. Thus, an activity which derives income in the form of capital gain, dividends, or interest will not be considered a passive activity unless it also derives a substantial portion of its income from a trade or business. The substantiality of income derived from trade or business activities is generally determined in a gross receipts sense. Thus, an activity with substantial business sales, but which lost money on these sales, generally would be treated as having substantial trade or business income. However, sham trade or business transactions (such as churning sales that were engaged in for the purpose of

permitting the activity to qualify as a passive activity) are disregarded.

An activity is excluded from treatment as a passive activity if the taxpayer materially participates in the activity or provides substantial personal services for the activity. In general, material participation has the same meaning as under the excess farm loss rule (including its application to certain retired and disabled persons and surviving spouses), except to the extent that, for activities other than farming, different specific types of participation may be relevant.

For example, in the case of an activity involving renting commercial real estate, the individual's activity with respect to commercial leases (whether involving participation in leasing specific units, deciding the terms on which leases should be offered, responding to tenant concerns, or any similar involvement) is presumably more relevant than performing physical work. An activity conducted by an individual may be excluded from treatment as a passive activity, even if the individual does not materially participate in management, if the individual provides substantial personal services with respect to the activity.

In general, "cash basis" has the same meaning for passive activities as for tax shelter farm activities. For example, in both cases, the same types of financing (e.g., partnership-arranged financing) are disregarded, and rules similar to those under subsections (b)(5) and (e) of Code section 465 apply.[14]

The excess passive loss rule applies on an aggregated basis, rather than, as with the excess farm loss rule, on a per-activity basis. Thus, in addition to aggregating income and loss from all passive activities, the taxpayer aggregates cash basis from all passive activities, for purposes of determining the amount of net loss that is not treated as a preference. Moreover, under the passive loss rule, the amount of cash basis that the taxpayer can take into account with respect to all tax shelters (as defined by section 461(i)(3)) cannot exceed $50,000 annually.

Consider, for example, the case of a taxpayer with $100,000 of cash basis in one or more passive activities that are not tax shelters, and $120,000 of cash basis in one or more passive activities that are tax shelters. This taxpayer would determine his or her net income or loss with respect to all passive activities (without distinguishing between tax shelters and other passive activities), and would have an excess passive activity loss only to the extent of losses in excess of $150,000 (i.e., all cash basis in non-shelter activities, plus $50,000 in cash basis of shelters). If this taxpayer had such losses in the amount of $150,000 or more, and nothing else occurred to change the amount of cash basis, in the succeeding year the taxpayer would treat as a preference only net passive losses, including losses carried over from the preceding year (as explained below), in excess of $50,000 (i.e. the lesser of $70,000 remaining

[14] However, in light of the one-to-one ratio between cash basis and allowable losses, a taxpayer who, for example, had losses of $80,000 and cash basis of $100,000 would reduce cash basis to $20,000. This treatment applies with respect to the passive loss rule even in the case of an activity that also constitutes a tax shelter farm activity (and that accordingly has basis reduced using a two-to-one ratio for purposes of the excess farm loss preference).

cash basis in tax shelters and the $50,000 annual limitation with respect to tax shelters.

Any amount treated as a preference under the excess passive activity loss rule is treated, for minimum tax purposes, as a carryforward to succeeding taxable years. Thus, for example, a taxpayer with a preference for excess passive activity losses in the amount of $10,000 (whether or not the taxpayer incurred minimum tax liability with respect to this amount) would treat the $10,000, for minimum tax purposes in the next taxable year, as a passive loss incurred in that year (i.e., a deduction in that amount would be allowed for minimum tax purposes, provided that, when considered in conjunction with other passive activity items of income and deduction for that year, it did not constitute an excess passive loss). Rules similar to those applying with respect to excess farm losses apply with respect to disposition of part or all of the taxpayer's interest in the activity.

4. Additional preferences applying to corporations

Reserves for losses on bad debts of financial institutions

As under the present law add-on corporate minimum tax, certain excess reserves of a financial institution to which section 585 or 593 applies are treated as a minimum tax preference. The preference is defined as equal to the excess of the reserve for bad debts deducted by the taxpayer over the amount that would have been allowable had the taxpayer maintained its bad debt reserve for all taxable years on the basis of actual experience.

Effect of section 291

For purposes of the corporate minimum tax preferences, the amount of a preference is measured after the application of section 291. Thus, for example, to the extent that a taxpayer's bad debt reserve is reduced for regular tax purposes pursuant to section 291, the amount of such reduction is not "double-counted" by being treated as a minimum tax preference.

5. Alternative minimum tax itemized deductions for individuals

In general, the alternative minimum tax itemized deductions for individuals are the same as those under the present law alternative minimum tax except for the treatment of charitable contributions of appreciated property, as explained above. Thus, the only "below the line" deductions allowable are deductions for casualty and gambling losses, charitable contributions, medical expenses in excess of 10 percent of AGI, qualified interest and the estate tax deduction under section 691(c).

6. Tax credits

Minimum tax credit

When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) generally is allowed as a credit against the regular tax liability (net of other nonrefundable credits) of the taxpayer in subsequent years. However, the minimum tax credit cannot be used to reduce minimum tax liability in

subsequent years. The minimum tax credit can be carried forward indefinitely; thus, it is not necessary for the taxpayer to determine which prior year's minimum tax credit is being used in a particular year. The minimum tax credit cannot be carried back.

In the case of an acquisition of assets of a corporation by another corporation to which section 381(a) applies (for example, a statutory merger), any unused minimum tax credits of the acquired corporation will be treated as a "tax attribute" that is taken into account by the acquiring corporation. However, for such an acquisition, as well as an acquisition of stock, the availability of the credits may be subject to limitation under the provisions of section 383.

In the case of an individual, the minimum tax credit is allowed only with respect to liability arising as a result of deferral preferences (i.e., preferences other than those that result in permanent exclusion of certain income for regular tax purposes). Thus, the amount of the net minimum tax is reduced by the amount of minimum tax liability that would have arisen if the only applicable preferences were the exclusion preferences. The exclusion preferences for individuals are those relating to net capital gain deductions, depletion, tax-exempt interest, foreign-earned income of U.S. citizens or residents, and charitable contributions of appreciated capital gain property.[15]

Consider, for example, the case of married taxpayers filing a joint return, with (i) no regular taxable income, (ii) deferral preferences in the amount of $300,000, and (iii) exclusion preferences (including disallowed itemized deductions) in the amount of $240,000. Under the 25 percent alternative minimum tax rate and the applicable $40,000 exemption amount, minimum tax liability would equal $125,000. However, if the taxpayers had had only exclusion preferences, minimum tax liability would have equalled $50,000 (25 percent of $240,000 as reduced by the $40,000 exemption amount). Thus, the amount of minimum tax available as a carryforward credit would be $75,000 ($125,000 less $50,000).

Foreign tax credit

Under the bill, minimum tax liability is defined as the excess of the tentative minimum tax (i.e. 25 percent of the excess of alternative minimum taxable income over the exemption amount, reduced by the specially computed foreign tax credit using the minimum tax base) over the regular tax (i.e. regular tax liability reduced by the foreign tax credit). The foreign tax credit is thus, in effect, allowable for purposes of the alternative minimum tax, under rules similar to those applying to the alternative minimum tax on individuals under present law. These rules involve separate application, for minimum tax purposes, of the section 904 limitation on the amount of the credit, to reflect the differences between regular taxable income and alternative minimum taxable income.

For example, to the extent that preferences allocable to U.S. source income, when taken into consideration for minimum tax purposes, decrease the ratio of foreign taxable income to worldwide income, or increase the amount of foreign tax paid that can be

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[15] In addition, for purposes of this rule, regular tax itemized deductions that are denied for minimum tax purposes are, in effect, treated as exclusion preferences.

taken into account with respect to the pre-limitation amount of the credit (due to the preference relating to section 911), the application of section 904 may lead to different results under the regular and the alternative minimum taxes, respectively. In light of these differences, taxpayers must separately keep track of the amount of foreign tax credit carryforwards allowable for regular and for minimum tax purposes.

Incentive tax credits

Nonrefundable credits other than the minimum tax credit generally are accorded treatment that is intended to have the same effect as the rules applying under the present law alternative minimum tax on individuals. However, the rules have been revised in one technical respect in the interest of simplicity. Under present law, nonrefundable credits can be claimed against the regular tax even if they provide no benefit (i.e., they reduce regular tax liability to less than the amount of minimum tax liability that was due in any case). To the extent that the credits provide no benefit due to the minimum tax, however, they are allowed as carryovers to other taxable years.

Under the bill, such credits generally cannot be claimed in the first place to the extent that they would reduce regular tax liability to less than tentative minimum tax liability and hence provide no benefit. As under present law, such credits are allowed as carryovers to other taxable years, under the generally applicable rules for credit carryovers.

Where no minimum tax is due and the minimum tax does not limit the use of incentive credits, the taxpayer is not required to file with his or her tax return a form showing minimum tax computations. For example, a taxpayer with $100 of regular tax liability (disregarding incentive credits), a targeted jobs tax credit in the amount of $10, and whose tentative minimum tax equalled less than $90, would not be required to file a minimum tax form with the Internal Revenue Service.

A special transition rule is provided in the case of a C corporation which has had net operating losses, under the definition applying for regular tax purposes, for two of its last three taxable years ending before January 1, 1986.[16] Such a taxpayer may use pre-1986 general business credit carryovers, both for regular and for alternative minimum tax purposes, to the extent necessary to offset no more than 75 percent of the tentative minimum tax for the taxable year.

The alternative minimum tax does not apply to any corporation that validly elects the application of section 936. Thus, a section 936 corporation is exempt from the alternative minimum tax, even to the extent that it has preference income that is not qualified possession source income.

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[16] A transition rule also applies with respect to specifically described public utility property which was constructed, reconstructed, or acquired pursuant to a written contract which was binding on December 31, 1980.

7. Net operating losses

Under the bill, special rules apply for net operating losses. These rules generally are the same as the present law rules with respect to the alternative minimum tax for individuals.

For purposes of the alternative minimum tax, net operating loss deductions are determined by using a separate computation of alternative minimum tax net operating losses and carryovers. Generally, this computation takes into account the differences between the regular tax base and the alternative minimum tax base.

The amount of the net operating loss (under section 172(c)) for any taxable year, for purposes of the alternative minimum tax, generally is computed in the same manner as the regular tax net operating loss, with two exceptions. First, the items of tax preference arising in that year are added back to taxable income (or, as with depreciation, adjustments relating to those items are made), and, second, for individuals, only those itemized deductions (as modified under section 172(d)) allowable in computing alternative minimum taxable income are taken into account. In computing the amount of deduction for years other than the year of the loss (i.e., carryover years), the recomputed loss is deducted from the alternative minimum taxable income (as modified under section 172(b)(2)(A)) in the carryover year (whether or not the taxpayer is subject to the minimum tax in that year).

For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses, of which $10,000 are preference items, the alternative minimum tax net operating loss for the year is $5,000. Thus, in any subsequent (or prior) year to which the loss may be carried, a $5,000 net operating loss deduction is allowed to reduce income subject to the alternative minimum tax.

Assume that, in year two, the taxpayer has $20,000 of alternative minimum taxable income (without regard to the net operating loss deduction). The taxpayer reduces his or her alternative minimum taxable income to $15,000 by the minimum tax net operating loss deduction. The net operating loss deduction for the regular tax is not affected by this computation (i.e., the taxpayer has a loss carryover of $15,000 from year one to be used under the regular tax).

For corporations, a transition rule generally allows, for purposes of the alternative minimum tax, all pre-effective date regular tax net operating losses to be carried forward as minimum tax NOLs to the first taxable year for which the tax, as amended under the bill, applies (and to subsequent years until used up). For individuals, present law is retained with respect to the calculation of alternative minimum tax net operating losses for such years.

An adjustment is required in the case of a corporation that had a deferral of add-on minimum tax liability for a year prior to 1986, under section 56(b), due to certain net operating losses. For such a corporation, no add-on minimum tax liability will be imposed after 1985, but the alternative minimum tax net operating loss for the year in which such deferred add-on minimum tax liability arose is reduced by the amount of the preferences that gave rise to the liability.

8. Regular tax elections

In the case of certain expenditures that would give rise to a minimum tax preference if treated under the rules generally applying for regular tax purposes, the taxpayer may make a "normative election," i.e., elect to have the minimum tax rule for deducting the expenditure apply for regular tax purposes. The expenditures to which this rule applies are the following: circulation expenditures, research and experimental expenditures, intangible drilling costs, and mining development and exploration expenditures. Elections can be made "dollar-for-dollar"; thus, for example, a taxpayer who incurs $100,000 of intangible drilling costs with respect to a single well may elect normative treatment for any portion of that amount.

To the extent that such an election applies, the item to which it applies is treated for all purposes, under both the regular and the minimum tax, pursuant to the election. No other deduction is allowed for the item to the extent that such an election applies.

An election made under this rule may be revoked only with the consent of the Secretary. Elections may be made at such time and in such manner as the Secretary by regulations prescribes. In the case of a partnership or S corporation, an election can be made separately by any partner (or shareholder) with respect to such individual's allocable share of any expenditure.

9. Other rules

The bill also contains certain miscellaneous rules affecting the application of the alternative minimum tax. For example, corporations are required to make estimated tax payments with respect to liability under the alternative minimum tax, in addition to the regular tax as under present law.

In the case of an estate or a trust, certain alternative minimum tax itemized deductions are allowable, and all items that are treated for regular and minimum tax purposes are to be apportioned between the estate or trust and the beneficiaries in accordance with regulations prescribed by the Secretary.

Rules for allocating items that are treated differently for regular and minimum tax purposes, respectively, are also provided with respect to common trust funds, regulated investment companies, and real estate investment trusts.

In addition, rules are provided relating to certain technical issues such as short taxable years and the application of exemption amounts with respect to companies filing consolidated returns. Finally, as under present law, the Treasury is instructed to prescribe regulations regarding the application of the tax benefit rule with respect to items that are treated differently for regular and minimum tax purposes, respectively.

Effective Date

The provisions apply to taxable years beginning after December 31, 1985.

Revenue Effect

With respect to individuals, the provision is estimated to increase fiscal year budget receipts by $800 million in 1986, $4,255 million in 1987, $5,170 million in 1988, $4,679 million in 1989, and $4,235 million in 1990.

With respect to corporations, the provision is estimated to increase fiscal year budget receipts by $1,171 million in 1986, $1,551 million in 1987, $909 million in 1988, $920 million in 1989, and $ 1,247 million in 1990.

TITLE VI. FOREIGN TAX PROVISIONS

A. Foreign Tax Credit Provisions

1. Separate Foreign Tax Credit Limitations (secs. 601 and 603 of the bill and sec. 904 of the Code)

Present Law

Foreign tax credit

The United States taxes U.S. persons[1] on their worldwide income, including their foreign income. Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being fully taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States. The foreign tax credit allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income.

A foreign tax credit is allowed for foreign taxes paid on income derived from direct operations (conducted, for example, through a branch office) or passive investments in a foreign country. A credit also is allowed with respect to dividends received from foreign subsidiary corporations operating in foreign countries and paying foreign taxes. The latter credit is called a deemed-paid credit or an indirect credit.

Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned in the United States.

The tax law imposes a limitation (first enacted in 1921) on the amount of foreign tax credits that can be claimed in a year that prevents a taxpayer from using foreign tax credits to offset U.S. tax on U.S. income. This limitation generally is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide taxable income (U.S. and foreign taxable income combined) between its U.S. and foreign taxable income. The ratio of the taxpayer's foreign taxable income to its worldwide taxable income is multiplied by the taxpayer's total pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign income and, thus, the upper limit on the foreign tax credit for the year.

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[1] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates.

Overall and per country limitations

Historically, the foreign tax credit limitation has been determined on the basis of total foreign income (an "overall" limitation or method), foreign income earned in a particular country (a "per country" limitation or method), or both.

Under an overall method, the taxpayer adds up its net income and net losses from all sources outside the United States and allocates its pre-credit U.S. tax based on the total. An overall method permits "averaging" for limitation purposes of the income and losses generated in, and the taxes paid to, the various foreign countries in which a taxpayer operates and other income and losses sourced outside the United States, such as those generated from shipping activity. An overall method also permits averaging of tax rates applied to different types of income—active and passive, lightly and highly taxed, for example.

Under a per country method, the taxpayer calculates the foreign tax credit limitation separately for each country in which it earns income. The foreign income taken into account in each calculation is the foreign income derived from the foreign country for which the limitation is being determined. Otherwise, a per country limitation is calculated in basically the same manner as an overall limitation.

Under a per country limitation, foreign taxes paid on income from sources within any particular foreign country can be used as credits by the taxpayer only against that portion of its total pre-credit U.S. tax that is allocable to that income. Thus, a per country limitation restricts the averaging of tax rates applied by different foreign countries. However, under prior law per country rules, some intercountry averaging could continue to be achieved through the use of a foreign holding company because earnings and taxes were not traced through tiered entities located in different foreign countries.

From 1921 until 1932, an overall limitation was in effect. Between 1932 and 1954, foreign tax credits were limited to the lesser of the overall or per country limitation amount. In 1954, Congress amended the law to allow only a per country limitation. From 1960 to 1975, Congress permitted taxpayers to elect between an overall and a per country method. Since 1976, an overall limitation has been mandatory.

The per country limitation rules of prior law permitted a taxpayer first to use the entire amount of a net loss incurred in any foreign country to reduce its U.S. taxable income. The taxpayer received a second tax benefit when in a later year, it earned income in the loss country and that country imposed tax on the income at a rate higher than the U.S. rate and had no net operating loss carryforward provision. A full foreign tax credit was allowed for that tax, eliminating the U.S. tax on the income, even though the earlier loss had reduced U.S. taxable income and, thus, U.S. tax, also. Congress repealed the per country limitation in 1976 to eliminate this double tax benefit.

Separate limitations

Under present law, the overall foreign tax credit limitation is calculated separately for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and passive interest income, respectively. Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income. The tax law sometimes disregards intermediate entities to apply these limitations correctly.

In general, a separate limitation is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated, the income typically bears little or no foreign tax, or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the averaging of that income, and the foreign taxes paid on it, with other types of income, and the foreign taxes paid on the latter income. Under the separate limitation for interest, for example, high foreign taxes paid on, for example, manufacturing income generally do not reduce the U.S. tax on interest income that is lightly taxed abroad. The separate limitations help to preserve the U.S. tax on foreign income that frequently bears little or no foreign tax while at the same time ensuring that double taxation is relieved with respect to each category of income.

Under present law, some categories of foreign income that are relatively manipulable with respect to source and that tend to be lightly taxed abroad are *not* subject to separate limitations. One example is dividends paid on portfolio stock investments. Just as the source of interest income can be shifted by making an investment in a foreign bank rather than in a U.S. bank, the source of portfolio dividend income can be shifted by buying stock of a foreign corporation rather than stock of a U.S. corporation. Similarly, the absence of applicable separate limitations permits a multinational entity to average foreign manufacturing income earned in a high tax country with shipping income that no foreign country taxes or that is subject to little foreign tax.

Anti-tax haven rules

In general, no current U.S. tax applies to the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income that are suited to tax haven operations. Under the Code's subpart F rules (Code secs. 951-64), when a U.S.-controlled foreign corporation earns this tax haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.

Subpart F income includes foreign personal holding company income, consisting generally of several types of passive income. Subpart F income also includes foreign base company shipping income (which excludes shipping income reinvested in shipping operations). (The subpart F rules are discussed in greater detail at C., below in connection with changes to those rules made by the bill.)

Foreign losses

If a taxpayer's foreign losses exceed its foreign income, the excess ("overall foreign loss") reduces the taxpayer's U.S. taxable income. Under the overall foreign loss recapture rule enacted in 1976, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (Code sec. 904(f)). Foreign taxable income up to the amount of the overall foreign loss may be so treated. However, unless the taxpayer elects a higher percentage, no more than 50 percent of the foreign taxable income earned in any particular year is treated as U.S. taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Foreign oil and gas extraction losses incurred abroad are treated separately from other foreign losses. Foreign extraction losses first reduce other foreign extraction income. If a taxpayer's foreign extraction losses exceed its foreign extraction income, the excess ("overall foreign extraction loss") first reduces the taxpayer's other foreign taxable income, then the taxpayer's U.S. taxable income. Overall foreign extraction losses are subject to a separate loss recapture rule (sec. 907(c)(4)) that operates in substantially the same manner as the general foreign loss recapture rule. Under the overall foreign extraction loss recapture rule, a portion of foreign extraction income earned after an overall extraction loss year is treated as foreign income other than foreign extraction income for foreign tax credit purposes. If an overall foreign loss includes an overall foreign extraction loss, both recapture rules will apply in a later year in which the taxpayer earns extraction income. The extraction income will first be recharacterized as U.S. income under the foreign loss recapture rule. Any extraction income not so recharacterized will then be subject to the overall foreign extraction loss recapture rule.

Present law does not specify whether, for foreign tax credit purposes, a loss in a separate foreign tax credit limitation "basket" first offsets foreign taxable income not subject to that particular separate limitation, or immediately offsets U.S. taxable income. Similarly, present law is unclear regarding whether a loss in the overall limitation basket first offsets foreign taxable income subject to the separate limitations, or immediately offsets U.S. taxable income. If such losses offset U.S. taxable income first, then the overall foreign loss recapture rule presumably would have to be applied separately to overall limitation income and to each separate limitation income basket. The Code does not specifically indicate that the overall foreign loss recapture rule is to be applied in this manner.

The committee understands that many taxpayers generally take the position that separate limitation and overall limitation losses immediately offset U.S. taxable income. If this position were upheld by the IRS, foreign tax credits effectively could reduce U.S. tax on *U.S.* income. As indicated above, this result would violate a basic premise of the credit: that it should reduce the U.S. tax on

foreign income only. Assume, for example, that a corporation has $100 of U.S. taxable income and $100 of foreign taxable income, the latter consisting of $200 of interest income subject to the separate limitation for interest and a $100 aggregate business loss in the income categories subject to the overall limitation. The corporation pays $80 of foreign tax on the interest income. The U.S. tax on $100 of U.S. source corporate income (assuming the bill's new maximum corporate tax rate applied) is $36. The pre-credit U.S. tax and the foreign tax credit limitation with respect to $100 of foreign source taxable income (making the same tax rate assumption) is also $36. If the corporation in this example allocates its $100 foreign business loss against its $100 of U.S. taxable income rather than against its $200 of foreign interest income, the corporation's separate limitation interest income for foreign tax credit purposes is $200 rather than $100. This allocation increases its separate foreign tax credit limitation for interest from $36 to $72. The larger limitation, in effect, lets the corporation reduce the U.S. tax on its U.S. taxable income (and its overall post-credit U.S. tax liability for the year) from $36 to zero. The $36 of foregone U.S. tax might be recaptured in later years under the foreign loss recapture rule if the corporation earns overall limitation income in later years; however, the U.S. Treasury is at risk that no such income will be earned in later years or, if it is, that no U.S. tax will be due when such income is earned.

Reasons for Change

The purpose of the foreign tax credit is to reduce international double taxation. Under the credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less any foreign income taxes imposed on that income. Under the overall foreign tax credit limitation, however, the United States sometimes collects little or no residual U.S. tax—after aggregate foreign taxes are credited—on a particular category of income that is itself taxed abroad at below the U.S. rate. The reason is the "averaging" of foreign tax rates generally permitted by the overall limitation: the overall limitation allows taxpayers to credit high foreign taxes paid on one category of income or to a generally high tax country against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

The committee believes that, in some cases, the present ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes and thereby reduce or eliminate the residual U.S. tax on their foreign income has undesirable consequences. Under present law, U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad at below the U.S. rate. This is because the excess credits will reduce or eliminate the U.S. tax on the lightly taxed foreign source income. This incentive is of particular concern in the case of investments that can quickly and easily be made in foreign countries rather than at home, for example, portfolio investments in stock in publicly traded companies. The committee is concerned that the incentive to choose foreign

over U.S. investment will be more pronounced in the future as a result of the bill's tax rate reductions: lower U.S. tax rates (relative to foreign tax rates) will cause many taxpayers to have more excess credits and more taxpayers to operate in excess credit positions.

The averaging allowed under present law also has the unintended effect of reducing the pressure on foreign countries to lower their tax rates.

The committee is also concerned that, absent modification of the foreign tax credit limitation rules, the averaging opportunities that present law provides, coupled with other features of the bill, could tilt the relative balance of U.S. tax rules favoring foreign investment and U.S. tax rules favoring U.S. investment in favor of foreign investment. Overall, the bill is estimated to increase substantially the U.S. tax on the aggregate U.S. source income of U.S. corporations, but not to increase significantly the U.S. tax on the aggregate foreign source income of U.S. corporations. Reducing averaging opportunities (along with some of the bill's other foreign tax provisions) reduces this disparity somewhat.

The existing separate foreign tax credit limitations for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and passive interest income, along with the special limitation for oil and gas extraction income, target specific averaging problems: DISC dividends bear no foreign tax and few foreign countries tax FSC income substantially; U.S. taxpayers can shift the source of passive interest income from the United States to foreign countries by, for example, withdrawing funds from U.S. banks and depositing them in foreign banks, and can secure a low rate of foreign tax on interest by making interest-bearing investments in foreign countries that either unilaterally, or pursuant to an income tax treaty with the United States, impose little or no tax on interest paid to a person not engaged in a trade or business in that country; foreign taxes on oil and gas extraction income are often abnormally high.

Several categories of income that are not presently subject to separate limitations present averaging problems similar to those presented by DISC dividends, FSC income, passive interest, and extraction income: that is, they frequently bear little foreign tax or abnormally high foreign tax, or are relatively manipulable as to source (U.S. or foreign). Like passive interest earned abroad by U.S. persons, passive income in general earned abroad by U.S. persons (for example, portfolio stock dividends, passive rents and royalties, passive commodity trading gains, and annuities) tends to bear little or no foreign tax. Also, many forms of passive income are manipulable as to source.

Income earned in the banking and insurance businesses, by its nature, is relatively movable; it may sometimes be shifted to low tax jurisdictions where excess credits from unrelated high tax business operations will shelter it from U.S. tax. The committee is concerned that the present foreign tax credit rules create too great an incentive for businesses to divert their resources into these activities abroad for tax purposes.

The committee also is informed that shipping income frequently is not taxed by any foreign country or is subject to very limited foreign tax. Under the overall limitation, U.S. multinational entities

with excess foreign tax credits from other business activities can earn such shipping income free of U.S. tax as well: their excess credits may shelter the shipping income from U.S. tax.

In light of these specific problems and the more general concerns expressed above, the committee believes that passive income, banking and insurance income, and shipping income should be subject to separate foreign tax credit limitations.

As indicated already, separate limitations function to reduce the averaging of foreign income and taxes, and the use of excess foreign tax credits, in connection with categories of foreign income that would otherwise pose particularly serious averaging problems. The committee does not believe that Congress intended separate limitations to allow taxpayers to use losses in separate limitation baskets, or in the overall limitation basket, to reduce U.S. taxable income before foreign taxable income. Congress repealed the per country limitation in 1976 specifically to prevent a net loss incurred in one foreign country from reducing U.S. taxable income before foreign taxable income earned in other foreign countries. As indicated above, using separate limitation losses to reduce U.S. taxable income before foreign taxable income inflates the foreign tax credit limitation, permitting the foreign tax credit to reduce in the loss year, and sometimes permanently, the U.S. tax on *U.S.* income. The committee believes that Congress should make clear that, for foreign tax credit limitation purposes, both separate limitation and overall limitation losses are to offset other foreign taxable income before they offset U.S. taxable income.

The allocation to other foreign income of a loss in the overall limitation basket will, by reducing that other foreign income, reduce the residual U.S. tax otherwise due on that income in the event that it is lightly taxed abroad. The allocation to foreign income subject to the overall limitation of a loss in a separate limitation basket will, by reducing the overall limitation income and hence the overall limitation, result in additional excess foreign tax credits in the event that the overall limitation income bears high foreign tax. The committee believes that these effects should be mitigated. This can be accomplished in a year or years following the loss year when income is earned in the loss basket by requiring a recharacterization of that income as income of the type previously reduced by the loss.

Explanation of Provisions

Overview

The bill subjects passive income, banking and insurance income, and shipping income to separate foreign tax credit limitations. The bill will prevent taxpayers from using high foreign taxes paid on other income to reduce or eliminate the U.S. residual tax on these income categories.

Subject to several modifications and exclusions discussed below, passive income, for this purpose, generally is any income of a kind which would be foreign personal holding company income as defined for purposes of the Code's anti-tax haven (subpart F) rules. The separate foreign tax credit limitation for passive income replaces the separate foreign tax credit limitation for passive interest

income. To prevent substantial averaging of foreign taxes and income within the passive "basket," the bill excludes from passive income income bearing relatively high foreign tax.

Income subject to the new separate limitation for banking and insurance income generally is any income derived in the conduct of a banking, financing, or similar business, and with certain additions, any income of a kind which would be insurance income as it is defined for purposes of the Code's anti-tax haven rules.

Income subject to the new separate limitation for shipping income generally is any income of a kind which would be foreign base company shipping income as it is defined for purposes of the Code's anti-tax haven rules.

In general, dividends, interest, rents, and royalties received from certain related foreign persons will be subject to the new separate limitations to the extent that the related persons themselves earn income of a type subject to the new separate limitations.

The bill also subjects any gain from foreign currency translation to a separate foreign tax credit limitation (sec. 661 of the bill). This separate limitation is discussed in connection with other changes made by the bill in the tax treatment of foreign currency transactions (see F., below).

In addition, the bill provides that separate limitation and overall limitation losses are to be allocated to other foreign income before U.S. income, subject to a recharacterization rule applicable in years following the loss year when income is earned in the loss basket.

Separate limitation income definitions

Impact of subpart F amendments

The bill expands the definitions of foreign personal holding company income, insurance income, and foreign base company shipping income for subpart F purposes and modifies the subpart F definition of a related person (sec. 621 of the bill). (These changes in the anti-tax haven rules are discussed in more detail at C., below.) In general, these definitional changes apply for separate limitation purposes as well. However, an exclusion from separate limitation passive income for active business rents and royalties and banking and insurance income (discussed in more detail below) limits the effect of the subpart F changes on the types of income subject to the separate limitation for passive income.

Passive income definition

Under the bill, passive income generally consists of any income received or accrued by any person which is of a kind which would be subpart F foreign personal holding company income (as defined in Code sec. 954(c), as amended by the bill). Thus, passive income for separate limitation purposes generally includes dividends, interest, annuities, and certain rents and royalties. The bill excludes from passive income any rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (as defined by new Code sec. 901(i)(1) (sec. 602(a) of the bill)), whether or not the rent or royalty is a same country rent or royalty (as defined by sec. 621(a) of

the bill). In general, it is anticipated that the standards contained in existing regulations defining rents and royalties for purposes of excluding such rents and royalties from subpart F taxation (Treas. Reg. sec. 1.954-2(d)(1)) will be followed in determining whether rents and royalties received from unrelated persons qualify for this exclusion from passive income. The committee expects that the Secretary, in adapting the standards contained in the existing regulations for this purpose, will appropriately take into account the fact that the persons receiving the rents and royalties will sometimes be U.S. persons rather than controlled foreign corporations. In addition, the committee expects that the Secretary, in adapting the standards contained in the existing regulations, will require any determination based on facts and circumstances (to the extent that the Secretary permits such a determination) to be consistent with the principles underlying the safe harbor rules of the existing regulations.

Banking or insurance income of a kind which would be foreign personal holding company income under the subpart F rules, as modified by the bill, is excluded from passive income to the extent that it is subject to the new separate limitation for banking and insurance income. That separate limitation is discussed in more detail below. Income that meets the definitions of both subpart F foreign personal holding company income and foreign base company shipping income is subject to the separate limitation for shipping income (discussed below), not the separate limitation for passive income.

Following subpart F definition of foreign personal holding company income, as modified by the bill, passive income also generally includes gain from the sale or exchange of property of a kind giving rise to dividends, interest, royalties, rents, or annuities that are subpart F foreign personal holding company income after the exceptions to the subpart F foreign personal holding company income inclusion rules are applied. Such gain is not subpart F or passive income if the person disposing of the property is a regular dealer in such property, for example, a regular securities dealer.

Also generally included in subpart F foreign personal holding company income and passive income under the bill is gain from any transaction (including a futures transaction) in any commodity. However, gains from commodity transactions are not subpart F or passive income when they (1) arise out of bona fide hedging transactions reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which that business is customarily and usually conducted by others, or (2) are active business gains from the sale of commodities, but only if substantially all of the taxpayer's business is as an active producer, processor, merchant, or handler of commodities.

Exchange gain attributable to any transaction, including a futures transaction, in a currency other than the taxpayer's functional currency generally is subpart F foreign personal holding company income and passive income under the bill. The exception from subpart F treatment under the bill for gain attributable to a currency transaction directly related to the business needs of the tax-

payer does not apply for passive basket purposes with respect to a taxpayer that uses the U.S. dollar as its functional currency.

As explained in more detail at C., below, the bill narrows the present law exclusion from subpart F foreign personal holding company income of certain dividends, interest, rents, and royalties received from related persons (Code sec. 954(c)(4)). The bill makes related party interest, rent, and royalty payments ineligible for the exclusion to the extent that they reduce subpart F income of the payor, and eliminates the exclusion entirely for interest received by a bank from a related bank.

The bill treats foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under the bill's new foreign investment company rules (sec. 625 of the bill)) as passive income subject to the separate limitation.

Passive income does not include any foreign oil and gas extraction income (as defined in Code sec. 907(c)).

Banking and insurance income definition

The new separate limitation for banking and insurance income applies to income received or accrued by any person which is derived in the conduct of a banking, financing, or similar business or from the investment made by an insurance company of its uninsured premiums or reserves ordinary and necessary for the proper conduct of its insurance business. Separate limitation banking and insurance income also includes, with one modification, any income which is of a kind which would be insurance income under subpart F (Code sec. 953(a), as modified by the bill). Subpart F insurance income under the bill generally is any income attributable to the issuing (or reinsuring) of any insurance or annuity contract. However, insurance income generally is not subject to current taxation under subpart F if the risk insured is in the country in which the insurer is created or organized. For purposes of the separate limitation for banking and insurance income, this same-country risk exception does not apply.

Under the bill, subpart F insurance income and, therefore, separate limitation banking and insurance income also include any income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premium for insurance of other-country risks.

The amount of insurance income subject to tax under subpart F and, therefore, subject to the separate limitation is the amount that would be taxed under subchapter L (as modified by the bill) of the Code if it were the income of a domestic insurance company (subject to the modifications provided in Code section 953(b)).

For purposes of the separate limitation, income derived in the conduct of a banking, financing, or similar business includes income earned in providing credit card and other services integrally related to banking and financing activity. It also includes finance leasing income.

As discussed in greater detail at C., below, the bill imposes current tax on all foreign personal holding company income earned by banks and insurance companies (subject to an exclusion for high-

taxed income) by repealing rules that presently exclude from foreign personal holding company income for subpart F proposes certain dividends, interest, and gains received by persons in the banking, financing, and insurance businesses. Banking and insurance income subject to current taxation under subpart F, as modified by the bill, is a narrower category of income than banking and insurance income subject to the new separate limitation, since the separate limitation is not limited in its application, as the subpart F inclusion rules with respect to banking and insurance income generally are, to foreign personal holding company income.

Shipping income definition

The new separate limitation for shipping income applies to income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in Code sec. 954(f), as amended by the bill). As discussed in more detail at C., below, the bill repeals the exclusion from foreign base company shipping income for reinvested shipping income and adds to base company shipping income certain income derived from space or ocean activities.

Interaction with subpart F rules

The types of income segregated under the bill for foreign tax credit limitation purposes will receive that separate treatment whether received by a U.S.-controlled foreign corporation, a U.S. person directly, or a related foreign person. Thus, for example, interest or dividend income that would have been subpart F foreign personal holding company income if received by a U.S.-controlled foreign corporation will be passive income (assuming that it is not subject to another separate limitation, for example, that for banking and insurance income) if received directly by a U.S. person.

In addition, the subpart F 10-percent de minimis and 70-percent full inclusion rules for foreign base company income (which includes foreign personal holding company and foreign base company shipping income) (Code sec. 954(b)(3)) will not apply for separate limitation purposes. Thus, a controlled foreign corporation whose only foreign base company income is, for example, foreign personal holding company income constituting less than 10 percent of its income, will be required to treat that foreign personal holding company income as separate limitation income to the extent that it would otherwise be so treated under the passive limitation rules. Similarly, U.S. shareholders in a controlled foreign corporation who are taxed currently on all of the corporation's income because the corporation's base company shipping income exceeds 70 percent of its income will be required to treat as separate limitation shipping income only that portion of the income that is foreign base company shipping income without regard to the 70-percent full inclusion rule. Foreign personal holding company and foreign base company shipping income received directly by U.S. persons (rather than through a controlled foreign corporation owned by them) will not be subject to the 10-percent or 70-percent rule either.

Also not applicable for separate limitation purposes is the subpart F rule (Code sec. 954(b)(4)) that excludes from foreign personal holding company income, foreign base company shipping income,

and, under the bill, subpart F insurance income (not attributable to U.S. risks) that income earned by a controlled foreign corporation that the taxpayer establishes was not availed of to reduce taxes.

Passive income that attracts high foreign tax

Passive income earned abroad sometimes bears relatively high, rather than low, foreign tax. For example, portfolio dividends (which generally are included in foreign personal holding company income) are sometimes subject to high gross withholding taxes. Also, taxpayers may take the position that they can allocate expenses in a manner that effectively shifts, for foreign tax credit limitation purposes, high taxes paid on nonseparate limitation income to passive income generated specifically for the purpose of such reallocation of foreign taxes. To ensure that the separate limitation for passive income segregates low-taxed income from high-taxed income as intended and that substantial averaging within the passive basket is avoided, the bill excludes high-taxed income from the passive basket.

For this purpose, high-taxed income is any income which would otherwise be passive income if the sum of the foreign income taxes paid or accrued by the taxpayer with respect to that income and the foreign income taxes treated as paid by the taxpayer with respect to that income exceeds the highest rate of U.S. corporate tax (36 percent under the bill) multiplied by the amount of the income (grossed-up for any deemed-paid foreign taxes pursuant to Code section 78). "Foreign income taxes," for this purpose, are any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.

This provision is similar in certain respects to Code section 954(b)(4), as modified by the bill, which will generally exclude from foreign base company income and insurance income (not attributable to U.S. risks) that income subject to an effective rate of foreign income tax greater than 90 percent of the maximum U.S. corporate tax rate. However, this provision, unlike the Code section 954(b)(4) provision, is self-executing. (Section 954(b)(4) applies only if a taxpayer establishes to the Secretary's satisfaction that its requirements are satisfied.)

The rule excluding high-taxed income from the passive income basket does not apply to income in either the banking and insurance income basket or the shipping income basket. This reflects the judgment of the committee that a bona fide bank, insurance company, or shipping company, while it should not be able to average its banking, insurance, or shipping income with any other, unrelated types of income, generally should be able to obtain the benefits of foreign tax rate averaging with respect to its active business income to the same extent that, for example, a manufacturing or service enterprise can.

Look-through rules

Dividends, interest, and rents and royalties received from certain related foreign persons will be subject to the separate limitation for passive income, the separate limitation for banking and insurance income, the separate limitation for shipping income, or the overall limitation in accordance with look-through rules that generally

take into account the extent to which the income of the payor is itself subject to one or more of these limitations. A dividend received by a 10-percent shareholder of the payor, for example, will not automatically be treated as 100-percent passive income because it is income of a kind which would be subpart F foreign personal holding company income. Subpart F inclusions are subject to a look-through rule too. The look-through rules are intended to reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (or through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation or other related foreign person.

The committee bill subjects interest, rents, and royalties to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation or other related foreign person. In addition, the committee believes that interest, rents, and royalties should be treated for separate limitation purposes at least as favorably as dividends eligible for a deemed-paid foreign tax credit[2] so that payment of the former will not be discouraged: interest, rents, and royalty payments generally are deductible in computing tax liability under foreign countries' tax laws while dividends payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of U.S.-owned foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest and royalties by controlled foreign corporations and other related foreign corporations whose dividends carry a deemed-paid credit may, therefore, reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends.

For purposes of the look-through rules, a related foreign person generally is any foreign corporation in which the taxpayer owns at least 10 percent of the voting stock.

Subpart F inclusions

The bill treats subpart F inclusions (Code sec. 951(a)) with respect to income of a controlled foreign corporation as income subject to the overall limitation, income subject to the separate limitation for passive income, income subject to the separate limitation for banking and insurance income, or income subject to the separate limitation for shipping income (as the case may be) to the extent attributable to income of the controlled foreign corporation subject to each of these limitations. Under Code section 951(d) (amended as part of the Tax Reform Act of 1984), an amount that would otherwise constitute both a subpart F inclusion and a foreign personal holding company inclusion (under Code sec. 551(a)) is treated as a subpart F inclusion. An amount that would otherwise constitute both a subpart F inclusion and a passive foreign investment company inclusion (under sec. 625 of the bill) also is to be treated as a subpart F inclusion for these purposes.

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[2] Absent an applicable look-through rule, interest, dividends, and passive royalties are generally fully subject to the separate limitation for passive income.

The look-through rule for subpart F inclusions may be illustrated as follows: Assume that a controlled foreign corporation wholly owned by a U.S. corporation earns $100 of net income. Ninety-five dollars of the income is foreign base company shipping income and $5 is interest from unrelated parties that is foreign personal holding company income for subpart F purposes. No foreign tax is imposed on the income. All of the income is subpart F income taxed currently to the U.S. parent corporation. Since $95 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for shipping income, $95 of the subpart F inclusion is treated as separate limitation shipping income of the parent corporation. Since $5 of the subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for passive income, $5 of the subpart F inclusion is treated as separate limitation passive income of the parent corporation.

Interest, rent, and royalty payments

The bill treats interest, rent, and royalties received or accrued from a related foreign person as income subject to the overall limitation, income subject to the separate limitation for passive income, income subject to the separate limitation for banking and insurance income, or income subject to the separate limitation for shipping income (as the case may be) to the extent properly allocable (under regulations prescribed by the Secretary) to income of the payor subject to each of these limitations. Under this rule, for example, royalties paid to a parent corporation by a subsidiary that itself earns only overall limitation income are treated as overall limitation income.

Under regulations, this rule will apply to interest, rent, and royalties received from foreign entities other than corporations in which the taxpayer has, directly or indirectly, a 10-percent or greater interest, in addition to interest, rent, and royalties received from foreign corporations in which the taxpayer has such an interest. The committee intends that interest, rent, and royalties be allocated for purposes of this rule using the same method used to compute the amount of any subpart F inclusion made with respect to the payor (see, e.g., Code sec. 954(b)(5)). This look-through rule replaces the related party interest exception (existing Code sec. 904(d)(1)(C)) to the present law separate limitation for interest. The bill also supplants the rules enacted in 1984 to maintain the separate limitation character of interest income (existing Code sec. 904(d)(3)).

The look-through rule may be illustrated as follows: Assume that a controlled foreign corporation wholly owned by a U.S. corporation earns $85 of gross income, consisting of $60 of gross income from manufacturing operations in its country of incorporation and $25 of interest on a loan to an unrelated foreign person. The manufacturing income is not subject to any separate limitation. The interest income is subject to the separate limitation for passive income. The foreign corporation incurs total expenses of $115, consisting of $85 of manufacturing expenses and $30 of interest payments to its U.S. parent. Thus, the foreign corporation incurs a net loss of $30 for the year. The foreign corporation owns assets with a

total fair market value of $500, consisting of assets used in its manufacturing operations worth $300, and a $200 loan to an unrelated foreign person. To determine how much of the $30 of interest payments to the U.S. parent is treated as separate limitation passive income of the U.S. parent, the payments must be allocated to gross separate limitation passive income and gross nonseparate limitation income of the foreign corporation. The asset method is used to allocate interest under the provision. Thus, $18 of the interest paid ($30 x $300/$500)) is allocated against the foreign corporation's $60 of gross manufacturing income and $12 ($30 x ($200/$500)) against the foreign corporation's $25 of interest income. Therefore, $12 of the $30 of interest paid by the controlled foreign corporation to its U.S. parent is treated as separate limitation passive income of the U.S. parent.

Dividends

The bill treats a portion of any dividend received from a related foreign person as overall limitation income, separate limitation passive income, separate limitation banking and insurance income, or separate limitation shipping income (as the case may be) on the basis of a separate limitation income ratio. For each of these limitations, the separate limitation income ratio of a dividend equals the separate limitation earnings and profits out of which the dividend was paid divided by the total earnings and profits out of which the dividend was paid. Under section 604 of the bill (discussed in detail below), dividends are considered to be paid from the multi-year pool of all of the distributing corporation's accumulated profits (in the case of actual distributions) rather than, as under present law, from the most recently accumulated profits of the distributing corporation.

Assume, for example, that a controlled foreign corporation wholly owned by a U.S. corporation has a net $100 loss in the current year. It pays a $200 dividend in the current year out of a four-year post-enactment pool of earnings and profits. Earnings and profits for the earlier taxable years were $1,000 and were not subject to any separate limitation. (They were derived from manufacturing and sales operations in the foreign corporation's country of incorporation; the U.S. parent had no subpart F inclusion with respect to the foreign corporation in the earlier taxable year.) In the case of each of the new separate limitations, the separate limitation income ratio with respect to the $200 dividend equals zero ($0/$900). Therefore, no portion of the dividend is treated as separate limitation passive income, separate limitation banking and insurance income, or separate limitation shipping income to the payor's U.S. parent.

As another example, assume that a controlled foreign corporation wholly owned by a U.S. corporation has a three-year post-enactment pool of earnings and profits of $990, none of which, as in the preceding example, has been previously taxed by the United States. Three hundred and thirty dollars of earnings and profits were earned in each of the three pool years. In the first year, $30 of the $330 total was foreign base company shipping income. The $30 avoided subpart F current taxation under the 10-percent de minimis exception for foreign base company income (Code sec.

954(b)(3)(A) as amended by section 623 of the bill). In the second year, $20 of the $330 total was foreign personal holding company dividends subject to the separate limitation for passive income. This $20 also avoided subpart F current taxation under the 10-percent de minimis exception. The foreign corporation pays a dividend of $200 out of the $990 of earnings and profits. The separate limitation shipping income ratio with respect to the $200 dividend equals 1/33rd ($30/$990). Therefore, 1/33rd of the $200 dividend, $6.06, is treated as separate limitation shipping income of the U.S. parent. The separate limitation passive income ratio with respect to the dividend equals 2/99ths ($20/$990). Therefore, 2/99ths of the $200 dividend, $4.04, is treated as separate limitation passive income of the U.S. parent.

Other rules relating to new separate limitations

The bill requires the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of the separate limitation rules, including regulations for the application of the look-through rules in the case of income paid through one or more entities. For example, a first tier controlled foreign corporation may receive interest or royalties from a second tier controlled foreign corporation. Such amounts will be characterized as separate limitation passive income, separate limitation banking and insurance income, or separate limitation shipping income of the first tier controlled foreign corporation by applying the look-through rule for interest, rent, and royalties described above to the second tier controlled foreign corporation's income. That look-through rule requires a determination of the extent to which the interest, rent, and royalties are properly allocable to separate limitation passive income, separate limitation banking and insurance income, or separate limitation shipping income of the second tier controlled foreign corporation.

The committee anticipates that regulations also will prescribe rules for determining the amount of foreign taxes considered paid for separate limitation purposes with respect to particular separate limitation passive, banking or insurance, shipping, or foreign currency translation income (as the case may be). To insure that the new separate limitations limit averaging as intended, the regulations will provide appropriate rules prohibiting the allocation to income subject to a particular separate limitation of foreign taxes that can be traced to other income.

The committee intends that foreign tax credit carryovers allowed for foreign taxes paid in pre-effective date taxable years reduce the U.S. tax in post-effective date taxable years only on income of the same limitation type as the income on which the carryover taxes were imposed. For example, foreign tax credit carryovers to a post-effective date taxable year that are allowed for foreign taxes paid in pre-effective date taxable years on income of a type subject to the new separate limitation for banking and insurance income are only to reduce the U.S. tax on banking and insurance income. Similarly, carryovers from the present law basket for interest are to reduce U.S. tax on post-effective date passive income. Similar rules are to apply to carrybacks: for example, post-effective date carrybacks to pre-effective date taxable years from the overall limitation

category may only reduce the U.S. tax on income of a type included in the new overall limitation basket.

Foreign losses

The bill provides that, for foreign tax credit limitation purposes, losses for any taxable year in separate foreign tax credit limitation "baskets" and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the taxpayer earns income in the loss year. Losses in all separate limitation baskets (enumerated in Code sec. 904(d)(1), as amended by the bill), including the passive, banking and insurance, shipping, and foreign currency translation income baskets, are subject to this rule.

A separate limitation loss recharacterization rule applies to foreign losses allocated to foreign income pursuant to the above rule. The recharacterization rule is similar to the overall foreign extraction loss recapture rule of present law (Code sec. 907(c)(4)). If a separate limitation loss or an overall limitation loss was allocated to income subject to another separate limitation (or, in the case of a separate limitation loss, to overall limitation income) and the loss basket has income for a subsequent taxable year, then that income (to the extent that it does not exceed the aggregate separate limitation losses in the loss basket not previously recharacterized under this provision) is to be recharacterized as income previously offset by the loss in proportion to the prior loss allocation not previously taken into account under this provision.

To the extent that that prior loss allocation, by reducing (for limitation purposes) foreign income that was subject to high foreign taxes, gave rise to additional excess foreign tax credits, the subsequent treatment of additional income as if it were such high tax foreign income will increase the foreign tax credit limitation in the year or years when the recharacterization occurs. To the extent that the loss allocation, by reducing (for limitation purposes) income that bore little or no foreign tax, reduced post-foreign tax credit U.S. tax liability in the loss year, the subsequent treatment of additional income as income of the type that bore little foreign tax will result in a recovery of some or all of the previously foregone U.S. tax revenue in the year or years when the recharacterization occurs.

The following is an example of how the bill's foreign loss allocation and separate limitation loss recharacterization provisions will operate: Assume a U.S. corporation earns $200 of U.S. income, $50 of foreign income subject to the separate limitation for passive income, and $150 of foreign income subject to the separate limitation for shipping income in a taxable year. The corporation also incurs a $100 overall limitation loss in that taxable year. Under the bill's foreign loss allocation rule, the $100 overall limitation loss is allocated on a proportionate basis among the foreign income baskets in which the corporation earns income in the loss year. Thus, $25 of that loss is allocated to its $50 of passive income and

the remaining $75 of the loss is allocated to its $150 of shipping income. None of the loss is allocated to its $200 of U.S. income. Thus, for foreign tax credit limitation purposes, the corporation has $25 of passive basket income, $75 of shipping basket income, and $200 of U.S. income for the taxable year.

In the following taxable year, the corporation earns $25 of passive basket income, $75 of shipping basket income, and $50 of overall limitation income. Because the corporation had a $100 overall limitation loss in the previous year that was allocated to separate limitation income in that year, its $50 of overall limitation income is recharacterized under the bill's separate limitation loss recharacterization rule as income of the type previously offset by that loss. That recharacterization is in proportion to the prior loss allocation. Thus, $12.50 of the overall limitation income is recharacterized as passive basket income and the remaining $37.50 of the income is recharacterized as shipping basket income. Thus, for foreign tax credit limitation purposes, the corporation has $37.50 of passive basket income, $112.50 of shipping basket income, and no overall limitation income in the second taxable year. Up to $50 of overall limitation income earned in any subsequent taxable year will be subject to the recharacterization rule because only $50 of the $100 overall limitation loss incurred in the first taxable year has been recharacterized.

Foreign taxes on income recharacterized under the separate limitation loss recharacterization rule are not themselves to be recharacterized. For example, foreign taxes on overall limitation income that is recharacterized as separate limitation income in a year following an overall limitation loss year may only be credited against U.S. tax on other overall limitation income.

For purposes of the bill's foreign loss allocation and separate limitation loss recharacterization provisions, the amount of a loss in a separate limitation basket or in the overall limitation basket is determined under the principles of the present law provision that defines foreign oil and gas extraction losses for purposes of the overall foreign extraction loss recapture rule (Code sec. 907(c)(4)(B)). Thus, a loss in the separate limitation basket or the overall limitation basket is the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to income in that basket is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under Code sec. 862(b) or 863). For this purpose, all foreign currency translation losses are allocated to foreign currency translation income before any other income.

If no foreign loss has been sustained in the case of an affiliated group of corporations filing a consolidated return, then no such loss is subject to recharacterization under this provision even if a member of the group had such a loss and the member is subsequently sold or otherwise leaves the group. In computing the amount of a foreign loss for purposes of the bill's foreign loss allocation and separate limitation loss recharacterization provisions, the net operating loss deduction (under Code sec. 172(a)) is not to be

taken into account. For purposes of these provisions, a taxpayer is to be treated as sustaining a foreign loss whether or not the taxpayer claims a foreign tax credit for the year of the loss.

In cases where a taxpayer realizes an *overall* foreign loss, both the overall foreign loss recapture rule of present law (Code sec. 904(f)) and the separate limitation loss recharacterization rule will apply. For example, if a U.S. corporation has a loss in the overall limitation basket of $100, $75 of separate limitation foreign income, and $100 of U.S. income, the $100 loss first offsets the $75 of separate limitation foreign income (under the bill's foreign loss allocation rule) and then offsets $25 of U.S. income. If, in a subsequent year, the corporation has $100 of overall limitation income, the prior year's $100 loss will first recharacterize $25 of that income as U.S. income under the overall foreign loss recapture rule and will then recharacterize the remaining $75 of that income as separate limitation income under the separate limitation loss recharacterization rule.

Effective Date

The provisions apply to taxable years beginning after December 31, 1985.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $275 million in 1986, $466 million in 1987, $452 million in 1988, $482 million in 1989, and $514 million in 1990.

2. Noncreditability of Certain Gross Basis Taxes and Subsidies (sec. 602 of the bill and sec. 901 of the Code)

Present Law

The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (Code secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it.[3] To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.[4]

Treasury regulations promulgated under Code sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-4 and 1.903-1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S.

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[3] *Biddle v. Commissioner*, 302 U.S. 573 (1938).

[4] *Bank of America National T. & S. Association v. United States*, 459 F.2d 513 (Ct. Cl. 1972).

sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country (a levy that is so conditioned is referred to as a "soak-up" tax).

Taxpayers who are subject to a foreign levy and also receive a specific economic benefit from the levying country are referred to as dual capacity taxpayers under the regulations. Dual capacity taxpayers may obtain a credit only for that portion of the foreign levy that they can establish was not compensation for the specific economic benefit received. A specific economic benefit is any economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the levying country, or, if there is no such generally imposed income tax, any economic benefit that is not made available on substantially the same terms to the population of the country in general. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls; or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not a soak-up tax. An earlier version of the regulation governing "in lieu of" taxes (Temp. Treas. Reg. sec. 4.903-1, T.D. 7739, filed November 12, 1980) required that a foreign levy be comparable in amount to the amount that would have been paid on the income involved had the general income tax of the levying country (or U.S. possession) applied to that income. The Treasury Department omitted the comparability rule from the final regulations after concluding that the statutory language of section 903 probably did not grant the Internal Revenue Service ample authority to promulgate such a rule.

The current regulations generally test the creditability of gross withholding taxes on interest under the "in lieu of" creditability rules of section 903 rather than under the general creditability rules of section 901. Such withholding taxes generally were tested for creditability under section 901 under prior regulations.

Present law imposes a special foreign tax credit limitation on foreign income taxes on income from oil and gas extraction (sec. 907(a)). Under this special limitation, otherwise creditable amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company may be credited only to the extent they do not exceed the highest U.S. corporate tax rate multiplied by the amount of such extraction income. Payments in excess of this limitation generally may be carried back and forward and credited against the U.S. tax otherwise due on extraction income earned in the carryback and carryforward years.

In addition, the foreign tax credit for taxes on foreign oil related income is limited by a comparability rule under present law (Code sec. 907(b)). Under this comparability rule, a foreign tax on oil related income is noncreditable to the extent that the Secretary de-

termines that the foreign law imposing the tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither foreign oil related income nor foreign oil and gas extraction income.

Treasury regulations allow a credit only for that amount of an income tax or "in lieu of" tax that is paid to a foreign country by the taxpayer. The Treasury regulations provide that the "taxpayer" is the person upon whom foreign law imposes legal liability for a tax. However, a tax is considered paid by the taxpayer even if another party to a transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's liability for the tax. Foreign borrowers frequently pay interest on loans from U.S. lenders "net" of income taxes. That is, the borrowers promise the lenders a certain after-foreign tax interest rate on the loans and agree to assume the lenders' liability for any foreign taxes imposed. The borrower may pay the taxes directly, pay additional interest to the lender equal to the tax the lender must pay, or reimburse the lender directly for the tax the lender pays. In general, under the regulations, foreign taxes paid by foreign borrowers pursuant to such arrangements are creditable in full by the U.S. lenders: the taxes are considered paid by the lenders notwithstanding that the foreign borrowers agree to pay them, provided that the levying country does not refund or otherwise forgive the taxes. However, in certain cases where the foreign borrower is a foreign government or is owned by a foreign government present law may be unclear regarding whether foreign taxes are creditable in full by the U.S. lender.

Under the Treasury regulations on creditability, a tax is not "paid" to a foreign country to the extent that it is reasonably certain to be refunded, credited, rebated, abated, or forgiven (Treas. Reg. sec. 1.901-2(e)(2)). To encourage foreign lenders to lend to their residents, some countries have attempted to subsidize foreign loans to their residents by rebating to their residents, directly or indirectly, all or a portion of the withholding taxes that the countries impose on the interest paid by the residents on loans from foreign lenders. Since the taxes are not formally rebated to the lenders, some U.S. lenders argue that they have "paid" the taxes and, therefore, should be granted foreign tax credits for them. The regulations disallow foreign tax credits in these cases, however. Under the regulations, a tax is not "paid" to a foreign country if it is used directly or indirectly as a subsidy to the taxpayer or certain related persons (Treas. Reg. sec. 1.901-2(e)(3)).

A U.S. lender can use the foreign tax credits granted for foreign taxes on interest (whether or not liability for the taxes is assumed by its foreign borrowers) to reduce or eliminate the lender's U.S. tax liability with respect to the interest income from the associated loans. In addition, under the overall foreign tax credit limitation, any excess foreign tax credits in connection with the loans may be used to reduce the lender's U.S. tax liability on other income it earns from the same foreign country or from other sources outside the United States.

Reasons for Change

A number of foreign countries, particularly developing countries, impose gross withholding taxes on interest earned by nonresident lenders that significantly exceed the general income taxes that they would impose on the associated net interest income, absent the withholding taxes. In the case of U.S. lenders, these gross withholding taxes often far exceed the pre-credit U.S. tax on the net interest income as well. When a gross withholding tax equals the pre-credit U.S. tax, the U.S. lender pays no U.S. tax on loan proceeds associated with interest subject to the withholding tax under the United States' generally applicable foreign tax credit rules. When a gross withholding tax exceeds the pre-credit U.S. tax, the U.S. lender is subject to a negative rate of U.S. tax on the foreign loan transaction (as other U.S. taxpayers operating abroad sometimes are on other foreign transactions) to the extent that the lender uses the excess foreign tax credits to reduce its U.S. tax liability on other income, derived from the same foreign country or from other sources outside the United States, that is subject to little or no foreign tax. Income from domestic loans, by contrast, generally bears U.S. tax. As a result of the foreign tax credit mechanism, the U.S. Treasury, in effect, bears the burden of these high levels of foreign tax on foreign loans.

The committee is concerned, moreover, that the available evidence suggests that the economic burden of high foreign gross withholding taxes on interest falls largely, in the typical situation, on the foreign borrower rather than on the U.S. lender. To the extent that is the case, the present rules allowing a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provide an incentive for some U.S. lenders to make foreign loans rather than domestic loans and to make otherwise uneconomical loans. The higher the applicable foreign tax on interest is, the larger the U.S. lender's foreign tax available for credit is and, thus, the greater the incentive may be. The committee is also concerned that foreign countries seeking to attract U.S. capital may be encouraged by the present rules to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. According to a January 1985 report in the Wall Street Journal, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to *exempt* from a Mexican withholding tax on interest the interest payments made by a Mexican state-owned food distributor to foreign banks.[5] The Mexican Government subsequently withdrew the exemption.[6] The incentive for foreign countries to increase their gross withholding taxes on interest may be particularly pronounced with respect to interest paid on loans to foreign governments because a foreign government generally suffers no economic detriment from a tax it imposes, in effect, on itself.

For the foregoing reasons, the committee believes that foreign gross-basis taxes on interest received by U.S. banks and other U.S.

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[5] S. K. Witcher, "Foreign Banks Worry Mexican Ruling Could Mean Loss of Tax Credits at Home," *Wall Street Journal*, Jan. 25, 1985, p. 24.

[6] S. Frazier & S. K. Witcher, "Debt-Swap Plan Is Proposed by Mexicans," *Wall Street Journal*, March 15, 1985, p. 29.

financial institutions should be creditable only to the extent of the pre-credit U.S. tax that would be imposed on the associated net interest income. Under such a rule, high foreign gross basis taxes on interest will continue, through the credit mechanism, effectively to exempt the associated net interest income from U.S. tax. However, such foreign taxes will no longer be available to reduce U.S. tax on other foreign income of a U.S. financial institution, so the incentive that some U.S. lenders have under present law to lend funds overseas rather than at home will be reduced. Applying this rule to high foreign taxes on interest is similar in many respects to the present law treatment of foreign oil and gas extraction taxes, the foreign tax credit for which is limited (in the case of U.S. companies) to the maximum pre-credit U.S. corporate tax payable on the associated extraction income.

As indicated above, a Treasury regulation denies a foreign tax credit for foreign taxes used directly or indirectly as a subsidy to the taxpayer. Absent this rule, the U.S. Treasury would, in effect, bear the cost of tax subsidy programs instituted by foreign countries for the direct or indirect benefit of their residents and certain nonresidents who do business with their residents. The committee is informed that some U.S. lenders and other U.S. taxpayers take tax return positions that are inconsistent with this rule. The committee does not believe that foreign tax credits should be allowed for foreign taxes which, while ostensibly imposed, are effectively rebated by the levying country by means of a government subsidy to the taxpayer, a related party, or a party to a transaction with the taxpayer. To eliminate any uncertainty in this area, the committee believes that the Treasury regulation disallowing foreign tax credits for taxes used as a subsidy to the taxpayer should be codified.

Explanation of Provisions

Under the bill, no foreign tax credit is allowed for any withholding tax (or other tax determined on a gross basis) imposed on interest income or its equivalent that is received or accrued by a bank, insurance company, or other financial institution or by any related person to the extent that the tax exceeds the U.S. tax which is attributable to the associated interest income. This provision will operate substantially as a separate foreign tax credit limitation does, except that any foreign tax credit disallowed under the provision will be treated as a noncreditable tax that cannot be carried back or forward. Any foreign tax credit disallowed under this provision will not be deductible.

For purposes of determining net interest income attributable to a given loan, all expenses and other deductions are to be allocated to the gross interest income from the loan using a method consistent with the method used in computing taxable income from foreign sources. The committee anticipates that regulations will provide reasonable guidelines for allocating expenses and grouping loans, where appropriate, so long as such allocation or grouping does not result in the averaging of withholding taxes above and below the applicable U.S. tax rate.

For purposes of the new rule, a related person is any individual, corporation, partnership, trust, or estate which has 50-percent control of, or is 50-percent controlled by, the taxpayer, and any corporation, partnership, trust, or estate which is 50-percent controlled by the same person or persons which have 50-percent control of the taxpayer.

Application of the new rule may be illustrated as follows: Assume a U.S. lender makes a $1,000 loan to a foreign borrower at a 10-percent annual interest rate. The lender's annual cost associated with the loan (including cost of funds and other properly allocable costs) is 8 percent of principal. The annual net interest income associated with the loan is $20 ($100 of interest income less the $80 annual cost associated with the loan). This net interest income is subject to $7.20 of pre-foreign tax credit U.S. tax (36 percent of $20). The borrower's country of residence imposes a 15-percent gross withholding tax on the $100 annual interest payments, that is, $15 of tax per year. Under the bill, this gross withholding tax is not creditable to the extent that it exceeds the $7.20 of U.S. tax attributable to the associated interest income. Therefore, $7.80 of the foreign tax ($15 less $7.20) is noncreditable and nondeductible.

The new rule applies to all foreign gross-basis taxes imposed on interest income received or accrued by the entities described above. The committee intends that, under regulations, other taxes on interest that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign financial institutions than residents also be subjected to the new rule.

The bill also contains a provision that is intended to codify Treas. Reg. sec. 1.901-2(e)(3). That regulation generally provides that any foreign government subsidies accorded in connection with foreign taxes reduce the creditable portion of such taxes. Under the bill, any income, war profits, or excess profits tax is not treated as a creditable tax to the extent that the amount of the tax is used, directly or indirectly, by the country imposing the tax to provide a subsidy by any means (such as through a refund or credit) to the taxpayer, a related person (within the meaning of Code sec. 482), or any party to the transaction, and the subsidy is determined, directly or indirectly, by reference to the amount of the tax, or the base used to compute the tax.

The committee is aware that the validity under current law of a ruling predating Treas. Reg. sec. 1.901-2(e)(3) that embodies its substance is being challenged in litigation pending in the U.S. Tax Court. No inference should be drawn from the committee's action as to the validity or invalidity of the regulation or ruling for years prior to the effective date of the bill.

Effective Date

In general, the provisions apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1985. However, in the case of the new creditability rule for gross-basis taxes on interest, a transitional rule is provided for certain loans to borrowers in certain less developed countries.

Under the transitional rule, the new creditability rule will not apply to a foreign tax imposed on interest accrued for periods before 1989 on a "qualified loan" to the extent that the amount of that foreign tax does not exceed certain limitations. These limitations are based on the rate of foreign tax imposed and interest paid on the loan on November 16, 1985, and the principal amount of the loan on that date, increased by 3 percent per year: thus, the transitional rule will not apply to the extent that the foreign tax on an otherwise qualified loan exceeds the foreign tax that would have been imposed on the basis of the rate of foreign tax applicable to that loan on November 16, 1985, the rate of interest on that loan on November 16, 1985, and the principal amount of that loan on November 16, 1985 increased by 3 percent of that amount in the case of interest paid or accrued during calendar year 1986, 3 percent of that amount (as previously increased) in the case of interest paid or accrued during calendar year 1987, and 3 percent of that amount (as previously increased) in the case of interest paid or accrued during calendar year 1988. The committee intends these limitations to apply on a loan-by-loan basis to qualified loans outstanding on November 16, 1985.

Subject to the limitations just described, a "qualified loan" is a loan made by the taxpayer which was outstanding on November 16, 1985 and which was made to a borrower in any of the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, the Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, or Yugoslavia. A loan resulting from the rollover, rescheduling, or restructuring of a qualified loan, and an increase in the principal amount of indebtedness to the taxpayer by an obligor of a qualified loan made by the taxpayer, also is to be treated as a qualified loan, subject to the above limitations.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $59 million in 1986, $94 million in 1987, $83 million in 1988, $241 million in 1989, and $295 million in 1990.

3. Deemed-Paid Credit (sec. 604 of the bill and secs. 902 and 960 of the Code)

Present Law

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. This is the "deemed paid" or "indirect" foreign tax credit.

Earnings and profits of a foreign corporation are generally not subject to U.S. tax as dividend income of a U.S. shareholder until repatriated through an actual dividend distribution. However, subpart F of the Code treats certain undistributed earnings and profits of a controlled foreign corporation as a current income inclusion of

U.S. shareholders who own 10 percent or more of the voting stock (taking into account attribution rules). A deemed-paid credit is also generally available to the U.S. shareholder with respect to such inclusions.[7]

In the case of an actual dividend distribution, the share of foreign tax paid by the foreign corporation that is eligible for the indirect credit is based on the share of that corporation's accumulated profits that is repatriated as a dividend to the U.S. corporate shareholder. Foreign taxes paid for a particular year are eligible for the indirect credit only to the extent that there are accumulated profits for that year and then only in proportion to the share of such accumulated profits that is attributed to the dividend distribution. Distributions are considered made first out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year are treated as paid out of the prior year's accumulated profits. The Internal Revenue Service has ruled that a foreign corporation's deficit in earnings and profits in any year reduces the most recently accumulated earnings and profits of prior years for purposes of matching prior years' foreign taxes with accumulated profits. Rev. Rul 74-550, 1974-2 C.B. 209.[8]

In the case of an income inclusion under subpart F of the Code, foreign taxes paid by the foreign corporation for the taxable year are eligible for the indirect credit only in proportion to the share of the controlled foreign corporation's earnings and profits of the year that is attributed to the subpart F inclusion.

For either an actual distribution or a subpart F inclusion, the amount of foreign tax eligible for the indirect credit is computed as a fraction of the foreign tax paid by the foreign corporation. The numerator of the fraction is the U.S. corporate shareholder's actual dividend or subpart F inclusion income from the foreign corporation. The denominator is the foreign after-tax accumulated profits (in the case of an actual dividend) or earnings and profits (in the case of a subpart F inclusion) attributed to the taxable year of the foreign tax. (The amount of foreign tax thus eligible for the indirect credit is also "grossed-up" and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax).[9]

Under this formula for computing the indirect credit, for any given dividend amount in the numerator of the fraction, a greater amount of accumulated profits (or earnings and profits) in the denominator of the fraction produces a smaller amount of foreign taxes allowed as a credit.

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[7] Unlike the deemed paid credit for actual dividend distributions, the deemed paid credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made.

[8] Compare *Champion International Corp.*, 81 T.C. 424, 442 (1983); *Pacific Gamble Robinson Co. v. U.S.*, 62-1 USTC Para. 9160 (W.D. Wash. 1961).

[9] For example, assume a foreign subsidiary earns $100 of income on which it pays $30 of foreign income tax. If a $35 dividend were paid (or if there were a $30 income inclusion under subpart F) out of the $70 of after-tax earnings, the U.S. shareholder would have a $15 indirect foreign tax credit (35/70 x $30) and $50 of income ($35 + $15). The "gross-up" prevents the U.S. corporate taxpayer from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of the actual distribution or subpart F inclusion reflects only after-foreign tax profits.

Both accumulated profits of a foreign corporation in the case of actual dividend distributions,[10] and earnings and profits of the foreign corporation, in the case of a subpart F inclusion (sec. 964(a)), are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes.

However, accumulated profits as calculated for purposes of the indirect credit with respect to actual distributions, and earnings and profits as calculated for purposes of the indirect credit with respect to subpart F inclusions may differ in several respects. For example, the subpart F rules (which Treasury regulations allow a U.S. corporate shareholder to elect to apply to actual distributions from a controlled foreign corporation) do not require adjustment to U.S. financial and tax accounting principles if the adjustment is not "material." Different foreign currency translation rules for actual and for subpart F deemed distributions are mandatory.

In the case of an actual dividend distribution, the first-tier foreign corporation making the distribution is generally deemed to have paid a proportionate share of the foreign taxes paid by a second-tier foreign corporation of which it owns at least 10 percent of the voting stock, and the same principle applies between a second and a third-tier foreign corporation; provided (in the case of a second or third-tier foreign corporation) that the product of the percentage ownership at each level equals at least 5 percent. Foreign taxes paid below the third-tier are not eligible for the deemed paid credit.

Subpart F inclusions are deemed included directly in the income of the U.S. shareholder. For example, a subpart F inclusion from a second or third tier foreign subsidiary is not treated as passing through any upper tier corporation; rather, it is an inclusion directly from the lower tier subsidiary. Thus, the foreign taxes and earnings and profits of that subsidiary are undiluted by and are not averaged with those of any upper tier company in determining the deemed-paid credit. The credit is not available, however, for inclusions from subsidiaries below the third tier. Percentage ownership requirements, similar to those applicable in the case of actual dividends, apply in order for inclusions from lower-tier subsidiaries to qualify for the deemed paid credit.

For purposes of the excess credit carryback and carryover provisions, foreign taxes eligible for the deemed-paid credit are considered paid in the year the U.S. corporation includes the related dividend in income, regardless of when the taxes were paid to the foreign country.

Reasons for Change

Under present law, when a foreign subsidiary has profits (subject to foreign tax) in some years and deficits in other years and does not distribute all its earnings currently, a portion of the foreign tax may never be creditable. For example, although there may be no foreign tax in a year in which a deficit occurs, the foreign law may not provide for a reduction in the foreign taxes paid in earlier prof-

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[10] *Steel Improvement & Forge Co.*, 36 T.C. 265 (1961); rev'd on another issue 314 F. 2d 96 (6th Cir. 1963); Rev. Rul. 63-6, 1963-1 C.B. 126; Treas. Reg. § 1.902-1(e); see *H.H. Robertson Co.*, 59 T.C. 56 (1972), aff'd in unpublished opinion (3d Cir., July 24, 1974).

itable years (i.e., the foreign country may not allow a loss carryback). In such a case, even if the subsidiary pays out all its net after-tax earnings at the end of the several years, the Internal Revenue Service takes the position that less than all the foreign taxes paid over those years will be eligible for the credit. This is because the deficit is viewed as reducing accumulated profits for the prior years in which the foreign taxes were paid, thus reducing the total amount of creditable taxes. *See* Rev. Rul. 74-550, 1974-2 C.B. 209. In a branch situation in which foreign income is taxed currently, this loss of foreign credits would not occur.

Present law also affects the availability of the deemed paid credit when a foreign corporation's effective foreign tax rate changes for any reason (for example, where foreign tax rates rise as a result of the end of a "tax holiday" or otherwise; where foreign tax rates decline; or where the effective foreign tax rates otherwise fluctuate from one year to another). It is advantageous under present law for foreign subsidiaries, where possible, to accumulate their earnings in years in which their effective foreign tax rate is low and distribute their earnings to U.S. parent corporations in years in which their effective foreign tax rate is high, rather than distributing their earnings on an annual basis with more constant dividends. Since, for purposes of computing the foreign taxes attributable to a dividend, the dividend is deemed distributed out of the subsidiary's earnings and profits for the current year first, drawing with them the foreign taxes with respect to those earnings, and then are treated as being derived from each preceding year, the distribution of dividends only in high tax years yields a higher foreign tax credit than the average foreign taxes actually paid by that foreign subsidiary over a period of years. This result would not occur in the case of a direct branch operation, since all income would be subject to U.S. tax currently and foreign taxes eligible for the credit would be taken into account currently.

Present law thus provides opportunities for the so-called "rhythm method" of dividend distributions from foreign subsidiaries. For example, suppose a U.S. parent corporation has two foreign subsidiaries and the foreign tax rate for each can be significantly lowered in one year at the cost of an increased rate in the next year, through timing the allowance of deductions and the recognition of income. Matters can be arranged so that the high and low tax years of the subsidiaries alternate, and the U.S. parent corporation takes the dividends it needs each year from the particular subsidiary that in that year has a high foreign rate.

The committee recognizes that there are difficulties in equating the foreign tax credit results of operation through a subsidiary and a branch, principally because of the deferral that is generally available to a subsidiary. However, the committee believes that steps to provide more similar results in the two cases are desirable. The committee bill adopts an approach, on a prospective basis, that computes the deemed-paid foreign tax credit of a U.S. shareholder with reference to the post-effective date accumulated foreign taxes and pool of accumulated earnings and profits (including all earnings and profits of the current year in the pool).

This pooling approach is intended to have two results. It is intended to alleviate the situation in which deemed-paid foreign tax

credits may be lost as a result of a deficit in a foreign corporation's earnings and profits. In addition, the committee intends to limit the ability of taxpayers to claim a deemed paid credit that reflects foreign taxes higher than the average rate over a period of years, by averaging the high-tax years and the low-tax years of the foreign corporation in determining the foreign taxes attributable to the dividend.

Explanation of Provision

For purposes of computing the deemed paid foreign tax credit, dividends or subpart F inclusions will be considered made from the pool of all the distributing corporation's accumulated earnings and profits. Accumulated earnings and profits for this purpose will include the earnings and profits of the current year undiminished by the current distribution or subpart F inclusion. The rule treating actual distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits is repealed. A dividend or subpart F inclusion is considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.

Earnings and profits computations for these purposes will be made under rules similar to those now required for subpart F deemed dividends (and permitted for actual distributions). However, the rules for translating foreign currency would be modified.[11]

Pooling will apply prospectively only. Future dividends will be treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that accumulated pool of post-effective date earnings and profits will be treated as paid out of pre-effective date accumulated profits under the ordering principles of present law.

The pooling provisions of the bill apply only for purposes of determining the deemed-paid foreign tax credit. For example, there is no change in the present law provisions limiting to current earnings and profits the amount that can be treated as a current subpart F inclusion to the controlled foreign corporation's shareholders. However, the deemed-paid credit with respect to such an inclusion is determined on the pooling basis, in order to limit opportunities to avoid the effect of pooling by creating subpart F inclusions.

There is no change in the present law provision that a subpart F inclusion from a lower-tier foreign subsidiary is deemed to be included directly in the U.S. shareholder's income without passing through any upper tier foreign corporation.

The Secretary of the Treasury is authorized to prescribe rules to implement the intent of these provisions. For example, the Secretary may consider whether or to what extent post-effective date distributions of pre-1985 profits from a lower-tier foreign subsidiary to an upper-tier foreign subsidiary will retain their pre-1985 character in the hands of the distributee corporation or will be treated as post-effective date earnings (and taxes) that are pooled at the upper-tier foreign corporation level.

In the case of a foreign corporation that does not have a 10 percent (direct or indirect) U.S. shareholder who would qualify for the

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[11] *See* discussion of currency, part F, below.

deemed-paid credit, as of the first taxable year the bill is generally effective, pooling will begin with the first day of the first taxable year thereafter in which there is such a 10-percent shareholder.

Effective Date

Dividends in taxable years beginning after December 31, 1985 are generally treated as made out of the pool of earnings for such years, to the extent thereof. If the first taxable year in which there is a 10 percent U.S. shareholder who would qualify for the deemed paid credit begins after 1986, then such taxable year is substituted for the first taxable year beginning after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $6 million in 1986, $21 million in 1987, $64 million in 1988, $91 million in 1989, and $103 million in 1990.

B. Source Rules

1. Determination of Source in Case of Sales of Personal Property (sec. 611 of the bill and secs. 861, 862, and new sec. 865 of the Code)

Present Law

Overview

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally insists on imposing its full tax on U.S. income. With respect to foreign persons, the source rules are primarily important in determining the income over which the U.S. asserts tax jurisdiction (foreign persons are subject to U.S. tax on their U.S. source income and some foreign source income that is effectively connected with a U.S. trade or business). Because the United States generally taxes the worldwide income of U.S. persons, the source rules are primarily important for U.S. persons in determining foreign source taxable income and, thus, in determining their foreign tax credit limitation. A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. For the foreign tax credit mechanism to function, then, every item of income must have a source: that is, it must arise either within the United States or without the United States.

Income derived from purchase and resale of property

Income derived from the purchase and resale of personal property, both tangible and intangible, generally is sourced at the location where the sale occurs. The place of sale generally is deemed to be the place where title to the property passes to the purchaser (the "title passage" rule). To the extent personal property is depreciable or subject to other basis adjustments (e.g., amortization), the gain attributable to the recapture of such adjustments is also sourced on the basis of the place of sale.

Income derived from manufacture and sale of property

Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under Treasury regulations, half of such income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale (determined under the title passage rule). The division of the income between manufacturing and selling activities must be made on the basis of an independent factory price rather than on a 50/50 basis, if such a price exists.

Income derived from intangible property

Royalty income derived from the license of intangible property generally is sourced in the country of use. For certain purposes, income derived from the sale of intangible property for an amount contingent on the use of the intangible is also sourced as if it were royalty income.

Withholding on certain intangible income

Present law provides that certain types of U.S. source income that are not effectively connected with the conduct of a trade or business in the United States are subject to U.S. tax on a gross basis. Such method of taxation is generally based on the premise that the foreign person does not have sufficient presence in the United States to allow for an accurate determination of the foreign person's expenses in order to tax the person on a net basis.

One of these types of income is gains from the sale of certain intangible property to the extent that the payments for the intangible property are contingent on the productivity, use, or disposition of such property (sec. 871(a)(1)(D)). A related provision (sec. 871(e)) treats gain on the sale of intangible property as being contingent on the productivity, use, or disposition of such property if more than 50 percent of such gain is actually from payments which are so contingent. This related provision also treats those gains as royalties for purposes of determining their source.

Reasons for Change

Source rules for sales of personal property should reflect the location of the economic activity generating the income at issue or the place of utilization of the assets generating that income. In addition, source rules should operate clearly without the necessity for burdensome factual determinations, limit erosion of the U.S. tax base and, in connection with the foreign tax credit limitation, generally not treat as foreign income any income that foreign countries do not or should not tax.

Although the title passage rule operates clearly, it is manipulable. It allows taxpayers to treat sales income as foreign source income simply by passing title to the property sold offshore even though the sales activities may have taken place in the United States. In such cases, the foreign tax credit limitation may be artificially inflated. In addition, foreign countries are unlikely to tax income on a title passage basis. Thus, the title passage rule gives U.S. persons the ability to create foreign source income that is not subject to any foreign tax, and that may ultimately be sheltered from U.S. tax with unrelated excess foreign tax credits. In addition, it gives foreign persons the ability to generate income that should be subject to U.S. tax.

Because the residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property, the committee believes that sales income generally should be sourced there. If the seller maintains a fixed place of business outside the seller's country of residence which materially participates in a sale, however, the committee generally believes that the level of economic activity with respect

to the sale that is associated with that place of business is high enough such that the location of that place of business should govern the source of the sales income.

With respect to sales to related parties, however, the committee does not believe that any relevant selling activity occurs. In this instance, the committee believes that the general rule assigning source to the seller's country of residence should control.

When a treaty prevents a foreign country from taxing a U.S. resident on income generated in the treaty country (e.g., because the U.S. resident does not have a permanent establishment there), it does so on the theory that the United States, as the residence country, will collect tax on that income. The committee does not believe, therefore, that it would be appropriate to treat that income as foreign source. If income that a foreign country has no jurisdiction to tax were treated as foreign source income, U.S. tax could be avoided in the event the U.S. resident had excess foreign tax credits from an unrelated activity.

In the case of personal property that is manufactured and sold by the taxpayer, the committee believes that an automatic 50-50 split of the associated income between U.S. and foreign sources does not always reflect the relative importance of the manufacturing and sales activities that generate the income. Recognizing that no rule which automatically splits income according to a fixed formula will reflect every factual situation, the committee nonetheless believes that a minimum of 50 percent of manufacture and sales income should be apportioned to the manufacturing activity since, in the majority of cases where intangible assets do not play a large role, the manufacturing activity predominates. The committee believes that the sales portion of such income should be sourced under the general residence-of-the-seller rule, with its exception for income attributable to sales in which a foreign fixed place of business materially participates.

The committee also believes that the title passage rule should not apply in determining the source of income from the disposition of property used in a person's trade or business. The committee believes that the source of income where prior deductions with respect to such property were allocated (for example, for depreciation) generally should govern the source of the income (up to the amount of the prior deductions) from the disposition of the property.

The committee also understands that most countries generally do not tax income attributable to inbound sales of intangibles when they are not made through a local fixed place of business. Therefore, the committee believes that it would generally be inappropriate to treat this income as foreign source. However, the committee understands that goodwill typically arises in the location where the business activity is conducted. In the case of goodwill, therefore, the committee believes that the location where the goodwill is generated should govern the source of income attributable to the goodwill.

As noted above, in the committee's view, the location of the economic activity which generates sales income generally should govern that income's source. The committee, therefore, generally believes that if a U.S. person conducts a trade or business in a for-

eign jurisdiction, that U.S. person should be considered a resident of that jurisdiction for purposes of sourcing the sales income attributable to that person's trade or business (in that jurisdiction), since that person should have sufficient presence in the foreign jurisdiction to be subject to local tax. The committee would not, however, treat a U.S. person as a foreign resident if the U.S. person were selling U.S.-manufactured products.

The committee also believes that, to the extent payments from the sale of intangible property are contingent on the use of such property, that income is more in the nature of a royalty for the use of property than gain from an outright sale of such property. The committee believes, therefore, in these circumstances, that the general residence-of-the-seller rule should not apply.

Explanation of Provisions

Income from the sale of personal property generally

The bill provides that income derived from the sale of personal property, tangible or intangible, by a U.S. resident is generally sourced in the United States. Similar income derived by a nonresident is treated as foreign source. For purposes of the bill, the term sale includes an exchange or other disposition. Also, any possession of the United States is treated as a foreign country for purposes of this provision.

The bill generally provides that an individual is a resident of the United States for this purpose if the individual has a tax home (as defined in Code sec. 911(d)(3)) in the United States. The bill provides that any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) generally is a U.S. resident for this purpose. All other individuals and entities generally are nonresidents for purposes of these source rules.

The bill contains an exception to the above described residence rules for U.S. citizens and resident aliens (within the meaning of sec. 7701(b)) in determining their residency for source purposes, however. The exception provides that a U.S. citizen or a resident alien is not treated as a resident of another country with respect to any sale of personal property unless the gain from the sale is actually taxed by such country. Thus, a U.S. citizen or resident alien cannot maintain a tax home in another country, sell his personal property, claim residency in such country, and generate foreign source income unless he or she actually pays tax on the income from such sale to that country.

The bill provides further exceptions to the general rule for determining residency when income is effectively connected with the conduct of a trade or business. If an item of income is effectively connected with the conduct of a trade or business in the United States by a nonresident, the nonresident is treated as a U.S. resident for purposes of determining the source of such income. The committee expects that the Code's existing "effectively connected" rules will be adapted for this purpose so that a determination can be made without regard to the source of an item of income.

Similarly, the bill provides that if an item of income is effectively connected with the conduct of a trade or business in a foreign country under U.S. effectively connected principles), a U.S. resident is

treated as a nonresident of the United States for purposes of determining the source of such income (except as otherwise provided in regulations). However, this residence rule does not apply to any inventory property that is produced in whole or in part in the United States. Assume, for example, a corporation is incorporated under the laws of the United States and is engaged in the exploration and development of oil and natural gas. Part of its operations include the exploration and development of an oil and gas deposit in a foreign country. Under U.S. effectively connected principles, the corporation is engaged in a trade or business in the foreign country and the income from the sale of oil and gas derived from that country is effectively connected with such trade or business. Under the bill, the corporation is a nonresident of the United States for purposes of determining the source of its income derived from the sale of oil and gas from its deposits in that foreign country. It is not a nonresident of the United States, however, for purposes of determining the source of oil and gas income derived from the sale of oil and gas from deposits in the United States.

The committee is aware that some of the source rules in the bill may conflict with source rules prescribed in U.S. income tax treaties. The source rules in the bill reflect the committee's policy that income not taxed, or not likely to be taxed, by a foreign country should not be treated as foreign income for purposes of the foreign tax credit limitations. The committee does not intend that treaty source rules should apply in a manner which would frustrate the policy underlying the source rules in the bill that untaxed income not increase a U.S. taxpayer's foreign tax credit limitation. The committee intends this treatment for all bill's source rules, not only those governing sales of personal property.

Income from the sale of inventory property

Under the bill, income derived from the sale of inventory property (as defined in sec. 1221(1), relating to stock in trade or other property primarily held for sale to customers in the ordinary course of its business) produced in whole or in part by the taxpayer is allocated between production activity and sales activity for sourcing purposes. The income allocated to production activity is sourced where the activity occurs (as under present law). The income allocated to sales activity is generally sourced under the residence-of-the-seller rule described above. Treasury regulations will be prescribed to allocate income between production activity and sales activity. The regulations are to require that at least 50 percent of the total income be allocated to production activity.

Income from the sale by a U.S. resident of inventory property produced by that U.S. resident that is allocated to sales activity, and income from the purchase and sale of inventory property by a U.S. resident, is sourced outside the United States only if (1) the property sold is for use, consumption, or disposition outside the United States, (2) an office or other fixed place of business outside the United States of the U.S. resident materially participates in the sale, and (3) the sale is not made to an affiliate of the U.S. resident. In this regard, an affiliate is any person bearing a relationship to the U.S. resident that is described in section 482. Thus, a U.S. resident generates foreign source income on the sale of inven-

tory property when a foreign office of the U.S. resident conducts a material part of the sales activity, the sale is to an unrelated person, and the property is not sold for use, consumption, or disposition in the United States. The bill provides, however, that a U.S. resident's office or fixed place of business in a foreign country is disregarded for purposes of determining the source of the U.S. resident's inventory sales income in the event a treaty between the United States and such foreign country prevents such country from imposing income tax on the income. In such a case, the income is U.S. source.

Income from the sale by a nonresident of inventory property produced by that nonresident that is allocated to sales activity, and income from the purchase and sale of inventory property by a nonresident, is sourced in the United States if the nonresident has an office or other fixed place of business in the United States and the sale is through that office or other fixed place of business. This U.S. sourcing rule does not apply, however, if the property is sold for use, consumption, or disposition outside the United States, an office of the nonresident outside the United States materially participates in the sale, and the sale is made to a nonaffiliate.

Income from the sale of depreciable personal property

Subject to a rule of convenience, the bill provides that gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to such income were previously allocated against U.S. source income. If the deductions giving rise to such income were previously allocated against foreign source income, gain from such sales (to the extent of prior deductions) is sourced without the United States. Any gain in excess of prior depreciation deductions is sourced pursuant to the rule described in the preceding paragraphs. That is, any gain in excess of prior depreciation deductions is generally sourced in the country of the residence of the seller.

Depreciation deductions, as defined in the bill, mean any depreciation or amortization or any other deduction allowable under any provision of the Code which treats an otherwise capital expenditure as a deductible expense. Depreciable personal property, as defined in the bill, means any personal property if the adjusted basis of the property includes depreciation adjustments. Depreciation adjustments are adjustments reflected in the adjusted basis of any property on account of depreciation deductions (whether allowed with respect to such property or other property and whether allowed to the taxpayer or to any other person).

The bill provides a rule of convenience for purposes of determining the source of income from the sale of certain depreciable personal property. This rule provides that if the property is either used predominantly in the United States or predominantly outside the United States for any taxable year, the taxpayer must treat the allowable deductions for such year as being allocable entirely against U.S. source or foreign source income, as the case may be. This rule is provided so as not to require a segregation of previously allowable deductions if the person knows the property was used predominantly in the United States or predominantly outside the

United States, as the case may be. A segregation of allowable deductions is required, however, for certain personal property generally used outside the United States (personal property described in sec. 48(a)(2)(B)). That is, the rule of convenience does not apply to such property.

Income from the sale of intangible property

The bill provides that in the case of income derived from the sale of intangible property, to the extent the payments are not contingent on the productivity, use, or disposition of the intangible, the general rule of this provision applies. That is, income derived from such sales is sourced in the country of the seller's residence. If payments are contingent on productivity, use, or disposition, the source rules applicable to royalties apply. For purposes of the bill, intangible property is any patent, copyright, secret process or formula, goodwill, trademark, trade name or other like property. Notwithstanding the general rule, income attributable to goodwill is sourced where the goodwill was generated.

The bill also repeals section 871(e) (relating to the treatment of certain payments from the sale of intangible property to the extent that such payments are contingent on the productivity, use, or disposition of such property). The bill provides that, for purposes of determining whether a withholding tax is due, taxpayers are to segregate the gain from the sale or exchange of applicable intangible property into gain contingent on the productivity, use, or disposition of such property and gain which is not so contingent. Withholding is required only with respect to U.S. source payments that are contingent on the productivity, use or disposition of such property.

Effective Date

The provision is generally effective for income earned in taxable years beginning after December 31, 1985. The provision is not applicable for income attributable to sales to unrelated parties during calendar year 1986 that were entered into under written binding contracts before January 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $170 million in 1986, $332 million in 1987, $379 million in 1988, $405 million in 1989, and $432 million in 1990.

2. Limitations on Special Treatment of 80-20 Corporations (sec. 612 of the bill and secs. 861, 862, 871, 881, 1441, and 1442 of the Code)

Present Law

Under present law, if U.S. source dividends and interest paid to foreign persons are not effectively connected with the conduct of a trade or business within the United States the withholding agent (which is generally the payor of such income) is generally required to withhold on the gross amount of such income tax at a rate of 30 percent (secs. 871(a) and 881(a)). The withheld tax constitutes the

only U.S. tax due by the foreign person for that income and the foreign person is not required to file a U.S. tax return. The withholding rate of 30 percent may be reduced or eliminated by tax treaties between the United States and a foreign country. Furthermore, withholding is not required on certain items of U.S. source interest income. For instance, the Tax Reform Act of 1984 eliminated withholding on U.S. source portfolio interest. The United States does not impose any withholding tax on foreign source dividend and interest payments to foreign persons, even if the payments are from U.S. persons.

Dividend and interest income generally is sourced in the country of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources (such a corporation is referred to as an "80-20 company"), all dividends and interest paid by that corporation are treated as foreign source income. Foreign countries generally do not tax dividends and interest paid by U.S. corporations to U.S. persons even though those dividends and interest may be foreign source under these rules.

Other exceptions to the country-of-incorporation source rules are designed as tax exemptions for limited classes of income earned by foreign persons. For instance, interest on foreign persons' U.S. bank accounts and deposits is exempt from U.S. withholding tax under current law. The current method of exempting this income is to treat it as foreign source.

Reasons for Change

The committee believes that the present rules for interest and dividends paid by 80-20 companies too often cede primary tax jurisdiction to foreign countries that do not tax such income either through a withholding tax or a net-basis tax. For example, interest payments by an 80-20 company doing business in a foreign country generally would not be subject to tax by the foreign country if paid to U.S. persons. In that case, the U.S. persons would receive foreign source treatment for income bearing no foreign tax. The committee understands, however, that in the case of Puerto Rico, outbound payments of U.S. corporations doing business there are subject to a withholding tax.

The committee is concerned that present law artificially inflates foreign source income for foreign tax credit limitation purposes. For example, if U.S. persons own the stock of an 80-20 company, the 80-20 company can distribute some foreign source dividends and interest to those U.S. persons. The U.S. shareholders' foreign tax credit limitations are increased as a result. Excess foreign tax credits may then be used to shelter the foreign source dividends and interest, which in all likelihood bore no foreign tax, from U.S. tax as well. This is true even though up to 20 percent of the earnings from which the dividends and interest are derived may have been U.S. source to the 80-20 company.

The committee believes, moreover, that the current rules encourage treaty shopping. For example, assume a foreign person in a foreign country has a wholly owned subsidiary in a second foreign country. Also assume that dividends and interest paid directly to the foreign parent company by its subsidiary would be subject to a

withholding tax by the second foreign country at a rate of 25 percent if that subsidiary were incorporated in that second foreign country. In this instance, if the United States has an income tax treaty with the second foreign country that reduces the withholding tax rates for dividends and interest below 25 percent, the foreign corporation might transfer ownership of its operating subsidiary to an intermediate 80-20 holding company incorporated in the United States and use the U.S. corporation as a conduit for repatriating its earnings from its operations in the second foreign country at a reduced rate of tax under the U.S. treaty. Alternatively, it might simply incorporate the operating subsidiary in the United States as an 80-20 company and operate through a branch in the second foreign country. In either case, because the interest and dividend payments by the 80-20 company to the foreign parent are foreign source, they bear no U.S. tax under present law. Where this structure is employed, the 80-20 company is generally structured with a high debt-to-equity ratio to minimize or avoid U.S. tax by payments of deductible interest at the 80-20 company level (in addition to avoiding tax at the shareholder level) on the income it earns.

The committee believes generally that there should be some shareholder-level tax burden associated with U.S. incorporation. In the example above, the United States would only be entitled to U.S. tax on the income attributable to the excess of the U.S. company's dividend income over its interest expense, which might be very small. In addition, the 80-20 company can use the deemed-paid foreign tax credit (sec. 902) which may eliminate any tax in the United States. The U.S. company is an 80-20 company which can then distribute the remaining earnings free of any shareholder-level tax if it is owned by foreign persons.

Explanation of Provision

The bill provides that interest paid by an 80-20 company is generally U.S. source income. The bill provides that dividends from an 80-20 company (other than a corporation that has an election in effect under Code sec. 936) are treated as U.S. source income.

The bill provides an exception from the U.S. source rule for certain interest received by a financial institution (as described in sec. 581 or 591) or by a similar foreign financial institution. Under this exception, interest income is foreign source if: (1) the interest paid by the payor corporation is attributable to the active conduct of a trade or business in a foreign country by the payor corporation a subsidiary or chain of subsidiaries of the payor corporation (or a partnership of which the payor corporation is a partner), and the payor corporation is an 80-20 company, (2) the payor corporation is not related to the financial institution, (within the meaning of sec. 901(i)(1)), and (3) the interest received by the financial institution is effectively connected with the conduct of a trade or business of the financial institution in a foreign country. Thus, for example, an 80-20 company engaged in an active trade or business in a foreign country pays foreign source interest to a branch of an unrelated U.S. bank or other U.S. or foreign financial institution as long as

the interest is effectively connected with the financial institution's trade or business in the foreign country.

The bill further provides that certain interest paid by an 80-20 company, though treated as U.S. source, is exempt from withholding. This exemption applies to interest paid (to a nonresident alien individual or other foreign person) by an 80-20 corporation if the interest paid by the 80-20 corporation is attributable to the active conduct of a trade or business in a foreign country by the 80-20 corporation, a subsidiary or chain of subsidiaries of the 80-20 corporation (or a partnership of which the 80-20 company is a partner). Thus, an 80-20 company conducting an active trade or business in a foreign country generally can borrow from a foreign person and not withhold U.S. tax on the interest payments as long as the interest is effectively connected with the 80-20 company's business. This exemption from withholding by an 80-20 company does not apply, however, if the 80-20 company is 50 percent owned (by voting power for all classes of stock entitled to vote or by value) by nonresident alien individuals or other foreign persons and the interest is paid to a recipient who is a related party (as defined in new Code sec. 901(i)(1)) to the payor. Thus, interest payments by a foreign-owned 80-20 company made to a related party are subject to U.S. withholding tax.

The committee also intends that this exemption from withholding apply to interest of an 80-20 corporation that is in a start-up phase of an active trade or business in a foreign country. The corporation can pay interest and not withhold U.S. tax as long as the interest is related to the corporation's start-up activities, the 80-20 company is not foreign owned, and the interest is not paid to related persons. A business is in a start-up phase if substantially all of its other expenditures are start-up expenditures (as described in sec. 195).

The bill further provides that certain other interest, although treated as U.S. source, is not subject to the withholding tax provided in sections 871 and 881. This interest, whether received by a nonresident alien individual or other foreign person, includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest. The bill also exempts from withholding tax the income derived by a foreign central bank of issue from bankers' acceptances. Under present law, these types of interest income are treated as foreign source income and thus are generally not subject to U.S. tax if paid to foreign persons; the bill treats them as U.S. source income but excludes them from withholding.

Effective Date

The provision is generally effective for dividends and interest paid in taxable years beginning after December 31, 1985.

The provision is not effective for interest paid on debt obligations held on December 31, 1985, unless the interest is paid pursuant to an extension or renewal of that obligation agreed to after December 31, 1985. In the case of interest paid to a related person that benefits from this grandfather rule, the payments are treated as payments from a controlled foreign corporation for foreign tax credit purposes. As such, they retain their character and source.

For dividends paid by a certain 80-20 company, the provision is not effective until January 1, 1991, for dividends paid on stock outstanding on May 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $12 million in 1986, $20 million in 1987, $22 million in 1988, $24 million in 1989, and $27 million in 1990.

3. Source Rule for Transportation Income (sec. 613(a) and 613(d) of the bill and sec. 861 and 863 of the Code)

Present Law

Under Treasury regulations, income or loss derived from providing transportation services generally is allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the territorial waters of the United States are treated as foreign expenses for purposes of this calculation. Under the Tax Reform Act of 1984, all transportation income attributable to transportation which begins and ends in the United States is treated as U.S. source income. Transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) generally is treated as 50-percent U.S. source income and 50-percent foreign source income. These provisions apply to both U.S. and foreign persons. For purposes of these provisions, transportation income is defined as any income derived from, or in connection with, the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, these source rules apply to transportation income attributable to both rental income (bareboat charter hire) and transportation services income (time or voyage charter hire). Also, these source rules apply both to companies earning transportation income and their employees, so that they apply to, for example, the income of personnel on ships. Transportation income includes income from transporting persons as well as income from transporting property. The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

If a foreign person is engaged in a trade or business in the United States and generates U.S. source transportation income effectively connected with that trade or business, the foreign person is subject to U.S. tax on a net income basis.

A special rule provides that income derived from the lease or disposition of vessels and aircraft that are constructed in the United States and leased to U.S. persons is treated as wholly U.S. source

income. Expenses, losses, and deductions incurred in leasing such vessels and aircraft are also wholly U.S. source. These rules apply regardless of where the vessel or aircraft may be used.

Another special rule applies to transportation income and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft is used on routes between the United States and U.S. possessions. This rule provides that all income and expenses of the lessor will be treated as U.S. source.

Reasons for Change

Under present law, a very small portion of transportation income is U.S. source. Thus, the majority of transportation income is treated as foreign source income. The committee believes that the U.S. source portion of transportation income should generally be greater than the amount determined under present law. The committee generally does not believe that persons should be able to generate foreign source income (or loss) unless the income (or loss) is generated within a foreign country's tax jurisdiction.

The operation of present law has two effects. First, for U.S. persons, it has the effect of increasing the foreign tax credit limitation of the carrier and affiliates with income that does not have a nexus with any foreign country. (Conversely, losses being treated as foreign source reduces the taxpayer's foreign tax credit limitation despite the absence of a nexus with a foreign country.) A carrier (or affiliates) with excess foreign tax credits from unrelated foreign operations may then utilize this increased foreign tax credit limitation to offset all or part of any U.S. tax that would otherwise be imposed on the transportation income. In this regard, a taxpayer with excess foreign tax credits has a competitive advantage over a taxpayer who does not have excess foreign tax credits.

Secondly, present law's understatement of U.S. source income tends to subject foreign persons to too little U.S. tax.

The committee also believes that the present law provisions that allow a lessor to treat losses (or income) from the lease of an aircraft as wholly U.S. source income do not reflect economic reality. The committee believes that some of the income or loss should be foreign source under the rules that apply to U.S. taxpayers generally.

Explanation of Provision

The bill provides that 50 percent of all transportation income attributable to transportation which begins or ends in the United States is U.S. source. The new provision applies equally to U.S. and foreign persons. The bill does not change the present law definition of transportation income. Also, as under present law, the committee does not intend that services performed in a foreign country that have an indirect connection with the transportation that begins or ends in the United States be subject to the bill's provisions.

The bill also repeals the special rule relating to the lease or disposition of vessels, aircraft, or spacecraft which are constructed in the United States (sec. 861(e)) and the special rule relating to the

lease of an aircraft to a regularly scheduled U.S. air carrier (sec. 863(c)(2)(B)). The source of such transportation income governed by these two special rules is determined under the general rule described above.

The bill only applies to transportation income attributable to transportation that begins or ends in the United States. Thus, if a voyage that begins in Europe has intermediate stops before it arrives in the United States, 50 percent of the income that is attributable to the cargo (or persons) carried from its port of origin to the United States is U.S. source.

The committee intends round-trip travel of persons (or cargo) by a carrier to be treated as transportation income attributable to transportation that begins (for the outbound portion), or ends (for the inbound portion), in the United States under the bill's provision. Thus, 50 percent of the income attributable to the outbound transportation and 50 percent of the income attributable to the inbound transportation is U.S. source. For example, 50 percent of the income attributable to the first and last legs of round-trip travel by a cruise ship, originating in the United States, calling on foreign ports, and ending in the United States is intended to be U.S. source. Similarly, 50 percent of the income attributable to both legs of an air carrier traveling from the United States, to a foreign country, and back to the United States (or from a foreign country, to the United States, and back to a foreign country), is intended to be U.S. source.

The bill's provision for income from transportation into the United States is intended to apply regardless of whether a foreign country treats the income from such transportation as within its taxing jurisdiction. For example, if a voyage from a foreign country to the United States is treated by the foreign country as income from domestic sources, 50 percent of the income from the voyage is still U.S. source for this purpose.

Section 613(b) of the bill (relating to tax on transportation income) provides definitive rules for when a foreign person is considered to have income which is effectively connected with the conduct of a U.S. trade or business. Section 613(b) provides that the foreign person is considered to have transportation income effectively connected with the conduct of a U.S. trade or business if the person has a fixed place of business in the United States which helps earn the transportation income, and substantially all of the person's U.S. source gross transportation income is attributable to regularly scheduled transportation. Therefore, the new sourcing provision for transportation income may substantially expand the amount of U.S. source income on which the foreign person is subject to tax.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 1985. Leasing income will continue to be sourced under prior law for income attributable to an asset owned on January 1, 1986, if the asset was first leased before such date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $14 million in 1986, $25 million in 1987, $23 million in 1988, $25 million in 1989, and $28 million in 1990.

4. Allocation and Apportionment of Expenses to Foreign Source Income (sec. 614 of the bill and sec. 864 of the Code)

Present Law

The Code provides, in general terms, that taxpayers, in computing net U.S. source and net foreign source income, are to deduct from U.S. and foreign source gross income the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

Treasury regulation sec. 1.861-8 sets forth detailed allocation and apportionment rules for certain types of deductions, including those for interest expense (and research and development expenditures, which are the subject of section 616 of this bill). These regulations, insofar as they govern interest expense, are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer regardless of any specific purpose for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Often, creditors of a taxpayer subject money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

In general, the regulation allows taxpayers to choose between two methods of allocating interest expense: an asset method and a gross income method. The regulation is based on the theory that normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore that the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. According to the theory of the regulation, apportionment of an interest deduction on such basis as gross income may not be reasonable. (Treas. Reg. sec. 1.861-8(e)(2)(v)). Therefore, the asset method is the preferred method.

Under the asset method, taxpayers generally may choose between two methods of evaluating assets, the tax book value method and the fair market value method. The tax book value method considers original cost for tax purposes less depreciation allowed for tax purposes. The fair market value method considers fair market value of assets, but it is available only if the taxpayer can show fair market value to the satisfaction of the Commissioner. Taxpay-

ers who use the fair market value method may not switch to the tax book value method without the Commissioner's consent.

If any taxpayer that is a member of an affiliated group that files a consolidated return uses the gross income method, then all members of the group must use the same method. Under the gross income method, taxpayers generally apportion the deduction on the basis of U.S. and foreign gross income. (Treas Reg. sec. 1.861-8(e)(2)(vi)). The allocation against foreign source income (or against U.S. source income) cannot be less than 50 percent of what the allocation would be if the taxpayer used the asset method.

Despite the general adoption of the approach that money is fungible, the regulation governing interest expense deductions provides a limited exception that allows taxpayers to trace interest expense to certain assets without treating that interest expense as fungible (Treas. Reg. sec. 1.861-8(e)(2)(iv)). That exception applies to only a limited class of nonrecourse debt.

Under the regulations, interest expense incurred by an affiliated group of corporations that files a consolidated tax return is required to be apportioned between U.S. and foreign income on a separate company basis rather than on a consolidated group basis. This separate company apportionment rule conflicts with a Court of Claims case, *International Telephone & Telegraph Corp.* v. *United States* (79-2 USTC para. 9649), decided under the law in effect prior to the effective date of the Treasury regulations. The ITT case indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income of a consolidated group on a consolidated group basis.

The regulations generally allow tax-exempt income and assets generating tax-exempt income to be taken into account in allocating deductible expense. Banks and other financial institutions, which may deduct some interest used to carry tax-exempt assets, are the main beneficiaries of this rule.

Taxpayers generally allocate expenses other than interest expenses on a company-by-company basis. The treatment of expenses for research and experimentation is discussed below in connection with section 616 of the bill.

Reasons for Change

Allocation and apportionment generally

The committee recognizes that proper rules governing the allocation and apportionment of expenses are essential to the proper functioning of the foreign tax credit limitation. Congress has heretofore addressed the expense side of the source question only in general terms, and has delegated to regulations the task of formulating rules governing expense allocation. The committee believes that these regulations have been manipulated, in some cases, to overstate foreign income. In other cases, the rules provide traps for the unwary.

The committee believes that it is important to reduce marginal U.S. tax rates. The committee is particularly concerned that lower U.S. rates will lead to more excess foreign tax credits. In this context, it is especially important to arrive at proper expense allocation rules.

In general, the committee does not believe that the approach of the existing regulations relating to the allocation of expense necessarily reflects economic reality. The committee believes that consideration of the expenses of the entire group of taxpayers that files a consolidated return is more likely to yield an appropriate determination of what expenses generate U.S. and foreign source gross income than is the separate taxpayer approach. In the case of corporations joining in the filing of a consolidated return, the committee believes that such consideration of group expenses can be accomplished with appropriate modifications of the separate company system of current law.

The committee has concluded that it is similarly appropriate to consider the entire group when taxpayers are eligible to be included in a consolidated return. The committee does not want to allow the use of deconsolidation (or failure ever to consolidate, in the case of new ventures) to defeat the more appropriate expense rules that it has developed for consolidated groups. The committee does not believe that imposition of this requirement on nonconsolidated filers who are eligible to consolidate will prove onerous. Instead, the committee anticipates that an affiliated group rule will keep taxpayers from seeking to avoid the rules governing consolidated groups.

The committee believes that it is inappropriate to consider assets that generate tax-exempt income in allocating and apportioning expenses. It is immaterial whether exempt income is U.S. source or foreign source. The inclusion of exempt U.S. source income and assets in the expense allocation increases the amount of expense allocated to U.S. source income even though the income generated is not subject to U.S. tax.

Interest expense

With limited exceptions, the committee believes that it is appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible. In this respect, the committee is adopting the theory of the Treaury Regulations governing the allocation of interest expense (see Treas. Reg. sec. 1.861-8(e)(2)(i)). It is inappropriate to apply the fungibility concept on the strict separate company basis of current law when a taxpayer is a member of an affiliated group and is included in a consolidated return. A similar rule should apply when a taxpayer is a member of an affiliated group, at least when the taxpayer is eligible to be included in a consolidated return. The strict separate company method of allocation has enabled taxpayers to limit artificially the interest expense allocated to foreign source income by adjusting the location of borrowing within the affiliated group. This may result in an unwarranted increase in the amount of foreign tax credits available to an affiliated group of corporations. In effect, present law allows taxpayers to arrange to have interest expense reduce U.S. income, even though that interest expense funds foreign activities (or frees up other cash to fund foreign activities), the income from which is sheltered from U.S. tax by the foreign tax credit or by deferral. Thus, not only is no U.S. tax paid on the foreign investment, but the investment generates negative U.S. tax on U.S. income. That is, present law allows corporations within a consolidated group to

reduce U.S. tax on U.S. income by borrowing money through one corporation rather than another.

The following examples illustrate the tax planning possibilities under current law.

Example 1

Assume that a U.S. corporation has $100 of U.S. and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurs $20 of interest expense. Its net income is $20 ($40-$20). The interest expense reduces gross U.S. income and gross foreign income equally, resulting in $10 of each.

The committee believes that the result of Example 1 is appropriate. Under the present Treasury regulations, however, if all the taxpayer's assets generate gross U.S. income, then all the taxpayer's interest expense reduces gross U.S. income. To avoid having interest expense reduce foreign income, taxpayers can isolate interest expense in a corporation whose assets produce only U.S. income. This rule creates opportunities for tax avoidance, as shown in Example 2.

Example 2

The facts are the same as Example 1, above, except that the U.S. parent corporation initially borrows cash and contributes the cash to the capital of a U.S. holding company (the sole asset of the U.S. parent) which then invests in foreign and domestic assets. These two corporations file a consolidated return. The U.S. holding company has $100 of U.S. assets and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurs no interest expense. It pays all its $40 of earnings to the parent as a dividend. Under the 100-percent dividends received deduction, the parent has no income from this dividend, but it has $20 of interest expense. This $20 reduces only U.S. income.[12] The group has $20 of foreign income (the interest expense now will not reduce foreign income) and $0 (zero) of U.S. income. If foreign tax credits shelter all the foreign income, the U.S. corporation can eliminate its U.S. tax.

In addition, as shown in Example 3, the current rules requiring allocation on a separate company basis may furnish a trap for the unwary. Alternatively, the conflict (described above) between the ITT case and the Treasury regulations governing interest allocation may allow some taxpayers to choose the allocation method (consolidated group or separate company) that produces less U.S. tax.

Example 3

U.S. corporation 1 owns $100 of U.S. business assets and U.S. corporation 2 owns $100 of assets that it uses in a foreign business. These corporations file a consolidated return. U.S. corporation 2 incurs $20 of interest expense, while corporation 1 incurs no interest expense. Under the regulations, this $20 would reduce only foreign gross income. Alternatively, under the theory of the ITT case,

[12] The holding company is a U.S. asset in the hands of the parent under present law as long as less than 80 percent of its gross income from the prior three years is foreign source.

this $20 would reduce U.S. gross income and foreign gross income equally.

Despite the committee's general adoption of the approach that money is fungible, it believes that a limited exception, like that now embodied in Treas. Reg. sec. 1.861-8(e)(2)(iv), that allows taxpayers to trace interest expense on certain nonrecourse debt to related assets will continue to be warranted.

Elimination of optional gross income method for allocating interest

The committee believes that the asset method more closely reflects economic reality than the gross income method. In this respect, the committee is adopting the theory of the Treasury Regulations concerning the general preferability of the asset method (see Treas. Reg. sec. 1.861-8(e)(2)(v)).

The gross income method has produced distortions under current law. For example, when taxpayers conduct their foreign operations through foreign subsidiaries, they allocate interest expense against only the net dividend they receive from the foreign subsidiary, not against the gross income that generated the net income that gave rise to the dividend. This rule tends to understate the allocation against foreign income and thus to overstate the allocation against U.S. income. This rule thus tends inappropriately to increase the foreign taxes that U.S. taxpayers can credit.

Improvement of asset method

Under current law, taxpayers using the asset method generally treat their basis in a subsidiary's stock as the amount to which they allocate expense. This stock basis amount does not reflect retained earnings. This failure to consider retained earnings has caused significant distortion. The bill's requirement that the asset method consider retained earnings of foreign subsidiaries appropriately takes account of some changes in value attributable to taxpayers' interests in controlled foreign corporations while the bill's look-through treatment of the assets of affiliated U.S. corporations provides appropriate treatment for domestic assets.

The committee does not believe that a general statutory requirement of annual valuation of assets is practical or administrable. Nonetheless, when taxpayers are willing and able to make annual valuations, then the committee believes that an asset method based on annual valuation is appropriate, so long as taxpayers may not switch from the fair market value method to the tax book value method without a reason satisfactory to the Commissioner.

Expenses other than interest

The committee has concluded that problems similar to those with the allocation of interest expense have arisen with other expenses such as general and administrative expenses. Thus, the committee has decided that the bill's general rule requiring treatment of a consolidated group as if it were one taxpayer is appropriate for expenses other than interest. For example, a U.S. parent corporation whose sole asset is stock of a U.S. holding company that owns U.S. and foreign assets may incur general and administrative expenses. The committee does not believe that, in such a case, it is appropriate to deduct all such expenses from U.S. source income. Instead,

within the context of the separate company system of current law, it is appropriate to adopt a "look through" approach for purposes of apportioning expenses incurred by the payee of dividends that are properly allocable to the class of income consisting of such dividends, so long as this approach yields the same results that would obtain under a one-taxpayer approach.

Explanation of Provisions

The bill provides, in general, that for purposes of the foreign tax credit limitation of section 904, the taxable income of each member of an affiliated group from sources outside the United States is to be determined by allocating and apportioning all interest expenses as if all members of the group were a single corporation. In effect, taxpayers will disregard stock of affiliates and interaffiliate debt in allocating interest expenses. As a result, the amount of foreign source and U.S. source income on the consolidated return in each of the three numbered examples in the Present Law section would be the same: there would be $10 of foreign source income and $10 of U.S. source income. The committee intends that regulations will provide appropriate treatment to effectively eliminate interest payments among members of an affiliated group that join (or could join) in the filing of a consolidated return. Therefore, the only interest expense taken into account is interest paid to non-members of the group. The bill does not change the treatment of non-recourse debt that the current regulation treats as definitely related to specific property (Treas. Reg. sec. 1.861-8(e)(2)(iv)).

The bill applies a similar rule in the case of expenses other than interest, but grants regulatory authority to the Secretary of the Treasury to provide exceptions, if any, as appropriate. For this purpose, too, taxpayers are, in effect, to disregard stock of affiliates and interaffiliate debt. Treating a consolidated group as if it were one taxpayer, however, will not change the present law allocation of directly allocable expenses. Similarly, it will generally not change the treatment of items such as labor costs or costs of materials, which, to the extent that they are elements of cost of goods sold, are generally not subject to allocation or apportionment. The committee anticipates that regulations will modify the separate company system of current law to provide look-through rules where appropriate to properly reflect all foreign source income earned by all members of the group.

The bill specifies that taxpayers are to allocate and apportion interest expense on the basis of assets rather than gross income. That is, the bill prevents taxpayers from using the optional gross income method of the current regulation (or any similar method) for allocating and apportioning interest.

The bill provides that tax-exempt assets and income associated therewith are not to be taken into account in allocating or apportioning any deductible expense. This rule applies to expenses other than interest. For this purpose, 85 percent of the basis (or value, if the taxpayer uses the fair market value method) of stock that pays dividends that are eligible for the 85-percent dividends received deduction is treated as a tax-exempt asset. As the 85-percent deduc-

tion changes in amount, the percentage of stock treated as a tax-exempt asset will change.

The bill provides a new rule for purposes of allocating and apportioning expenses on the basis of assets when the asset is stock in one of certain foreign corporations. In general, for this purpose, the adjusted basis of any asset which is stock in a controlled foreign corporation in the hands of a 10-percent U.S. shareholder is to be increased by the amount of the earnings and profits of the foreign corporation attributable to that stock and accumulated during the period the taxpayer held it. For this purpose, the adjusted basis of stock in a controlled foreign corporation is also to reflect capital contributions. In the case of a deficit in earnings and profits of the foreign corporation that is attributable to the stock that arose during the period when the 10-percent U.S. shareholder held it, that deficit is to reduce the adjusted basis of the asset in the hands of the U.S. shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

The bill's one-taxpayer rule also provides new treatment under the asset method for stock in affiliated U.S. companies. The committee intends that stock of affiliates and intercompany debt between affiliates be disregarded under appropriate rules prescribed by the Secretary. Therefore, as members of an affiliated U.S. group earn income that they retain, that income will be reflected in assets whose tax basis will be considered in the allocation of expenses under the asset method. This treatment is comparable to the treatment that the bill provides for stock of foreign corporations.

An example illustrates the operation of the one-taxpayer rule and the asset method improvement. A U.S. parent company has borrowed $360 with an obligation to pay annual interest of $36. The debt is recourse debt, so the use to which the taxpayer puts the borrowed funds is immaterial under the bill. The U.S. parent borrower owns two assets. One of its assets is stock of a domestic subsidiary; that stock has a basis in the parent's hands of $800. The U.S. subsidiary in turn owns the following assets: U.S. assets which have a basis in its hands of $700, and foreign assets which have a basis in its hands of $100. The other asset of the U.S. parent (the borrower) is stock in a foreign corporation. The basis of the stock in the foreign corporation in the hands of the U.S. owner is $100. The foreign corporation also retained earnings of $100.

Under the bill, after a transition period, the interest expense allocation rules will operate on the basis of the affiliated group consisting of the U.S. parent corporation and its U.S. subsidiary. The parent will be treated in effect as owning directly the $700 of U.S. assets owned by the U.S. subsidiary and the $100 of foreign assets owned by the U.S. subsidiary. In addition, the parent will be treated as owning $200 of foreign assets by virtue of its $100 basis in the stock of the foreign subsidiary increased by the $100 of earnings and profits of the foreign subsidiary. Thus, the parent is treated as owning $700 of U.S. assets and $300 of foreign assets for the purpose of the asset method. Therefore, 70 percent of its interest expense ($700/$1000) will reduce U.S. source gross income. The parent corporation will allocate $10.80 (30 percent of $36) against foreign source income and $25.20 (70 percent of $36) against U.S.

source income. The same result would obtain if the U.S. subsidiary had borrowed the money and paid the interest.

The bill contains an exception to the rule requiring treatment of an affiliated group as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense. That general rule will not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. If this exception applies, the financial institution will not be treated as a member of the group for applying the bill's general "one taxpayer" rule to other members of the group. The other members of the group will still be treated as one taxpayer for interest expense allocation purposes. The financial institution will still be part of the group that the bill treats as one taxpayer for expenses other than interest.

The bill requires the Secretary to prescribe such regulations as may be necessary to carry out the purposes of these provisions. In particular, the committee intends that, in the case of an affiliated group of corporations that is eligible to file a consolidated return but that does not do so, the foreign source income of any member of the group shall not exceed the amount of foreign source income that would be attributable to that member if the group were a single corporation. For example, assume that two U.S. corporations, although eligible to file a consolidated return, do not do so. Corporation 1 owns all the shares of Corporation 2. Corporation 1 has $20 of gross income, all from sources within the United States, and incurs $20 of interest expense. Corporation 1 has no net income after interest expense. Corporation 2 has $20 of gross income, all from sources without the United States, and incurs no interest expense. Corporation 2 has $20 of net income. The committee intends that under regulations the foreign source income of this group of two corporations will not exceed what it would have been had they filed a consolidated return. Had they done so, the group would have had $10 of net U.S. source income, and $10 of net foreign source income. Therefore, the foreign source income of Corporation 2 cannot exceed $10. It will be treated as earning $10 of U.S. source income and $10 of foreign source income.

In addition, the committee intends that regulations provide appropriate safeguards to prevent the transfer of assets from one consolidated group member to another to achieve a fair market value basis without recognition of gain (until the asset leaves the group).

Effective Date

In general, these provisions apply to taxable years beginning after December 31, 1985. Transitional rules apply to the allocation of interest expense, however.

A general three-year "phase-in" transitional rule applies to all the elements of the interest expense allocation (including the change to consider an affiliated group as one taxpayer, the elimination of the gross income method, and the improvement of the asset method). This "phase-in" rule provides that for the first three tax-

able years of the taxpayer beginning after December 31, 1985, the bill's interest expense allocation rules apply only to an applicable percentage of interest expense paid or accrued by the taxpayer during the taxable year. That applicable percentage is determined with respect to an amount of indebtedness that does not exceed the amount outstanding on November 16, 1985. This three-year phase-in rule applies whether the taxpayer borrows from the same lender from which it borrowed on November 16, 1985, or from other lenders. In the case of the first taxable year, the applicable percentage is 25 percent; in the case of the second taxable year, the applicable percentage is 50 percent; in the case of the third taxable year, the applicable percentage is 75 percent.

Thus, for example, under the three-year "phase-in," if a calendar year taxpayer's debt outstanding on November 16, 1985, was $100, and its debt outstanding at all times during 1986 is $75, the bill will not affect interest expenses paid or accrued during that second taxable year.

A separate transitional rule applies only to the rule requiring consideration of the affiliated group for determination of interest expense (the first sentence of new sec. 864(e)(1)). That rule considers recently incurred indebtedness. In the case of an increase in the amount of a taxpayer's outstanding debt on May 29, 1985, over the amount of the taxpayer's outstanding debt on December 31, 1983, the interest expense rule that requires consideration of the affiliated group shall be phased in over five years. In the case of the first taxable year beginning after 1985, the rule applies only to 16-2/3 percent of the interest expenses paid or accrued by the taxpayer on the increase in indebtedness. In the case of the second taxable year beginning after 1985, the rule applies to only 33-1/3 percent of the interest expenses paid or accrued by the taxpayer, and so on, until the rule applies to 83-1/3 of interest expenses in the fifth taxable year beginning after 1985, and to all interest expenses thereafter.

A similar separate four-year transitional "phase-in" rule applies to certain increases in indebtedness incurred during 1983. In the case of the first four taxable years of the taxpayer beginning after 1985, with respect to interest expenses attributable to the excess of the amount of the outstanding debt of the taxpayer on January 1, 1984, over the amount of the outstanding debt of the taxpayer on December 31, 1982, then the "one-taxpayer" rule will apply only to the applicable percentage of interest expenses paid or accrued by the taxpayer during the taxable year. In the case of the first taxable year, the applicable percentage is 20; in the second year, 40; in the third year, 60; and in the fourth year, 80.

For the purpose of the 5-year phase-in and the 4-year phase-in, any indebtedness outstanding at the end of 1985 shall be treated as attributable first to the excess incurred after 1983 but before May 29, 1985 (and thus eligible for the 5-year phase-in), then to indebtedness incurred in 1983 (and thus eligible for the 4-year phase-in), and then to other indebtedness.

Finally, a limited 3-year phase-in applies to a limited class of debt of a certain group including a corporation incorporated in 1964.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $172 million in 1986, $434 million in 1987, $689 million in 1988, $885 million in 1989, and $1,148 million in 1990.

5. Source Rule for Space and Certain Ocean Activities (Sec. 615 of the bill and secs. 861 and 863 of the Code)

Present Law

Under present law, income from activities conducted in space or outside the territorial waters of foreign countries takes many forms: manufacturing occurs in space, spacecraft are leased, contracts for personal services are executed for persons in space, and payments are made for other actual business operations conducted in space, such as research and development. Similarly, income from activities conducted outside the territorial waters of foreign countries can take many of the same forms: lease income, personal service income and business income. The source of space and "high seas" income is therefore dependent on the type of activity performed. Lease income is generally sourced in the place of use; personal service income is generally sourced where the services are performed; and business and manufacturing income is generally sourced where the activity is performed. Therefore, because the equipment is generally used, the services generally performed and the activities generally conducted outside the United States, the predominant part of income from space and high-seas activities is foreign source income under present law.

A special rule provides that certain income from leasing vessels, aircraft, or spacecraft is U.S. source (Code sec. 861(e)). This provision is applicable if the vessel, aircraft, or spacecraft is leased to U.S. persons, is eligible for the investment tax credit and is manufactured or constructed in the United States. Because most tangible property used predominantly outside the United States is not eligible for the investment tax credit, the special rule has only limited application for spacecraft (exceptions to the predominant use test exist for, among others, vessels documented under the laws of the United States, certain communications satellites, and certain property used in the Outer Continental Shelf or in certain international waters, sec. 48(a)(2)(B)).

Reasons for Change

The foreign tax credit rules are designed to prevent double taxation of income by the United States and foreign countries. The credit generally operates on the principle that the country in which income arises has the primary right to tax the income. In order to prevent the foreign tax credit from offsetting more than the U.S. tax on income which is potentially subject to double taxation, the credit is limited to the taxpayer's pre-credit tax on its foreign source income. In view of the purpose to prevent double taxation, the source rules used in computing the limitation are generally designed to identify as foreign source income that income which might reasonably be subject to foreign tax.

The present rules governing the source of income derived from space or high seas activities produce results that do not meet the above standard. Where a U.S. taxpayer conducts activities in space or international waters, foreign countries generally do not tax the income. Thus, the foreign tax credit limitation may be inflated by income that is not within any foreign country's tax jurisdiction.

Accordingly, in order to allow the foreign tax credit mechanism to function as it is designed, the committee believes that income from space or high seas activities should be sourced in the country of residence of the person generating the income. This will allow the residence country to reserve primary tax jurisdiction over the income.

Explanation of Provision

The bill provides that all income from space or ocean activities is sourced in the country of residence of the person generating the income: income derived by a U.S. resident is U.S. source income and income derived by a nonresident is sourced outside the United States. For these purposes, the terms U.S. resident and nonresident have the same meaning as assigned to them in section 611 of the bill (Code sec. 865, regarding the new source rules for income derived from the sale of personal property).

Space or ocean activities as defined by the bill include any activities for the use (or hiring or leasing for use) of a spacecraft and any activities conducted on or beneath water not within the jurisdiction (as recognized by the United States) of any country including the United States or its possessions. The term ocean activities also includes any activities performed in Antarctica.

Space or ocean activities do not include any activity which gives rise to transportation income (as defined in sec. 863(c)) or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

The bill also provides an anti-conduit provision to apply in the case of certain foreign corporations. A foreign corporation is to be treated as a U.S. resident if 50 percent or more in value, of the corporation is owned (within the meaning of sec. 958(a)) or considered as owned (under the principles of sec. 958(b)) by U.S. persons. Thus, U.S. persons cannot incorporate a foreign corporation in order to be taxed as a nonresident of the United States for this purpose. This provision applies regardless of the number of persons interposed between the corporation earning the income and its ultimate owners.

As provided in sec. 613(d) of the bill, Code sec. 861(e), relating to certain income from leasing vessels or spacecraft that is treated as wholly U.S. source, is repealed.

Effective Date

The provision is effective for income earned in taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $10 million annually through fiscal year 1990.

6. Two-Year Modification in Regulation Providing for Allocation of Research and Experimental Expenditures (sec. 616 of the bill)

Present Law

Foreign tax credit and source rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset U.S. tax on foreign source taxable income, but not U.S. source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the amount of foreign tax that a taxpayer may credit.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-863 require taxpayers to apportion expenses between foreign source income and U.S. source income. A shift in the apportionment of expenses from U.S. to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the amount of foreign tax that a taxpayer may credit.

Research and experimental expense allocation regulation

Treasury Reg. sec. 1.861-8 (published in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead these expenses are associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular political entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that political entity's jurisdiction. If so, the associated research expense reduces gross income only from the geographic source that includes that jurisdiction.

After research expenses incurred to meet legal requirements are allocated under the above rule, any remaining research expenses are generally apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expenses are identified to the taxpayer's total worldwide sales receipts in that product group (the "sales" or "gross receipts" method). However, the regulation provides that a

taxpayer using the sales method may first apportion 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed. Thus, for example, a taxpayer who performs two-thirds of his research and development in the United States may automatically apportion at least 30 percent of his remaining research expense to U.S. source income. A taxpayer can choose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if he establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion his research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions his research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, he may not use an optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S. and foreign source income using these methods may not be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance apportionment methods. If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of his research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer apportions to the income grouping with respect to which the 50-percent limitation is not satisfied, 50 percent of the amount of his research expense which would have been apportioned to that income grouping under the sales and place-of-performance methods. A taxpayer electing an optional gross income method may be able then to reduce the amount of his research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) is exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 is divided evenly between U.S. and foreign source income, using the sales method. Under the optional gross income methods, the $35 of research expense allocated to foreign sources could be reduced as much as 50 percent, to $17.50. This could occur, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation.

The optional gross income methods apply to all of a taxpayer's gross income, not gross income on a product category basis.

Treas. Reg. sec. 1.861-8 generally requires a smaller allocation of research expense to foreign source income than a predecessor regulation proposed in 1973 would have required.[13]

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of Code sec. 174) which were paid or incurred in those taxable years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA). This two-year moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 was effectively extended for two additional years by the Tax Reform Act of 1984. Under the 1984 Act (sec. 126), for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of Code sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States.

One reason Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance resulted in unduly high foreign taxes and that, absent changes in the foreign tax credit limitation, U.S. taxpayers would lose foreign tax credits. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under Treas. Reg. sec. 1.861-8 on U.S.-based research activities and on the availability of the foreign tax credit. While that study was being conducted by the Treasury and considered by Congress, Congress concluded that expenses should be charged to the cost of generating U.S. source income, whether or not such research was a direct or indirect cost of producing foreign source income.

In June 1983 the Treasury Department submitted its report on the mandated study to the House Committee on Ways and Means and the Senate Committee on Finance.[14] In summary, the Treasury report concluded that:

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[13] See 38 Fed. Reg. 15,840 (1973).

[14] See Department of the Treasury, *The Impact of the Section 861-8 Regulation on U.S. Research and Development* (June 1983).

The moratorium reduced U.S. tax liabilities. Had Treas. Reg. sec. 1.861-8 fully been in effect in 1982, the Treasury Department estimated that the $37 billion in privately financed U.S. research and development spending in 1982 would have been reduced by approximately $40 million to $260 million as a result of increased U.S. tax costs. Most of the reduction would have represented a net reduction in overall research and development undertaken by U.S. corporations and their foreign affiliates, rather than a transfer of research and development abroad.

The moratorium reduced the tax liabilities only of firms with excess foreign tax credits. Whether or not a firm had excess foreign tax credits did not seem to be closely related to the level of its research and development efforts.

The moratorium had its most significant effect on large, mature multinationals as opposed to small, relatively young high-technology companies. Of the estimated increase in U.S. tax liabilities for calendar 1982 that would have occurred had Treas. Reg. sec. 1.861-8 been fully in effect, about 85 percent was estimated to be accounted for by 24 U.S. firms on the list of the 100 largest U.S. industrial corporations compiled by *Fortune Magazine*.

An allocation of research expense to foreign income could increase a taxpayer's worldwide tax liability if the foreign government did not allow the apportioned expense as a deduction. Some allocation to foreign income, however, was appropriate on tax policy grounds when U.S. research and development was exploited in a foreign market and generated foreign source income. If an allocation were not made, foreign source taxable income would be too high and the higher limitation could allow the credit for foreign tax to reduce U.S. tax on U.S. source income.

The research and development rules of Treas. Reg. sec. 1.861-8 reflected significant modifications of the 1973 proposed version of the regulation in response to taxpayer comments. Compared to the 1973 version of the regulations, these modifications allowed less research expense to be allocated to foreign source income and recognized that research and development conducted in the United States might be most valuable in the U.S. market.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by Congress in 1984. The extension was intended to allow Congress to consider further the results of the Treasury study on the Treasury research expense allocation rules.

Reasons for Change

The moratorium on the application of the Treasury research expense allocation rules was intended to encourage the performance of research in the United States. While the committee believes that the Federal tax law should generally encourage U.S.-based re-

search activity, it has concluded that the moratorium—under which all U.S. incurred research expense is allocated to U.S. source income—is a relatively inefficient and inequitable means of promoting research in the United States. As a matter of tax policy, the committee is of the view that it is appropriate to require the allocation of deductible expenses (including research expenses) between U.S. and foreign source income. A tax incentive for research that conflicts with this basic tax policy principle should not, in the committee's view, be retained at least absent a showing that it is the best such incentive device available. Accordingly, the committee has decided not to renew the expired moratorium on the application of the Treas. Reg. sec. 1.861-8 research expense allocation rules.

Because of the importance of U.S.-based research activity, the committee will continue to study whether any additional permanent tax incentives for U.S. research might be appropriate. The committee considers it important that the relative equity and efficiency of alternative tax incentives be fully analyzed before any decision is made to adopt an additional permanent tax incentive.

While the committee and Congress study these issues further (for a two-year period), the bill provides temporary rules for allocation of research expense that are based on the approach of the Treasury regulation, but that liberalize the Treasury regulation in certain respects. For many taxpayers, these temporary rules will substantially increase the portion of U.S.-based research expense allocable to U.S. source income over what that portion would be if the regulation were fully applicable. These temporary modifications to the regulation's allocation rules are intended only to provide an additional tax incentive to conduct research in the United States while Congress analyzes whether any additional permanent incentive is necessary or feasible. Like the expired moratorium, the temporary modifications are an incomplete incentive device since they can reduce the tax liabilities only of firms with excess foreign tax credits. The temporary modifications do not reflect a judgment by the committee that any provision of the existing Treasury research expense allocation rules is necessarily inadequate or inappropriate.

Explanation of Provision

Under the bill, for taxable years beginning generally after August 1, 1985, and on or before August 1, 1987, the application of the Treas. Reg. sec. 1.861-8 research expense allocation rules is effectively liberalized in three respects. These liberalizations apply notwithstanding other changes made by the bill in the Code's expense allocation rules (sec. 614 of the bill).

The bill retains the regulatory rule (Treas. Reg. sec. 1.861-8(e)(3)(i)(B)) under which research expenditures are allocated entirely to one geographic source if they were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. For the specified two-year period, the bill provides that 50 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures will be appor-

tioned to U.S. source income and deducted from such income in determining the amount of taxable U.S. source income. The bill thus has the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 50 percent. Under the bill, a taxpayer will be able to apportion to U.S. source income 50 percent of his U.S.-based research expense remaining after any allocation of such expense incurred to meet legal requirements.

The bill further provides that, for the specified two-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remains after any legal requirements allocation and the 50-percent automatic place-of-performance apportionment will be apportioned on the basis of sales or gross income. Thus, the bill makes automatic place-of-performance apportionment available temporarily to taxpayers who elect to apportion expenses using the optional gross income method, as well as to taxpayers choosing the standard sales method of apportionment. The bill also has the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent over what the allocation to foreign source income would be under the standard sales method.

The bill's temporary modifications to the Treas. Reg. sec. 1.861-8 research expense allocation rules apply for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States. The modifications apply only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income. They do not apply for other purposes, such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. They also do not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

Effective Date

The provision generally applies to taxable years beginning after August 1, 1985 and on or before August 1, 1987 only. However, if the taxpayer's third taxable year beginning after the general effective date of the Economic Recovery Tax Act of 1981 (August 13, 1981) was eligible for the present law moratorium on the application of the Treasury research expense allocation rule under a special effective date provision (sec. 126(c)(2) of the Tax Reform Act of 1984), then the provision also applies to the taxpayer's first two taxable years following that third taxable year.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $243 million in 1986, $436 million in 1987, and $160 million in 1988.

C. Taxation of U.S. Shareholders of Foreign Corporations

1. Expansion of subpart F income subject to current U.S. taxation (sec. 621 of the bill and secs. 953 and 954 of the Code)

Present Law

In general

Two different sets of U.S. tax rules apply to American taxpayers that control business operations in foreign countries. The use or non-use of a foreign corporation determines which rules apply. (To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.)

Direct operations—current tax

One set of rules applies to U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation). The income from those operations appears on the U.S. tax return for the year the taxpayer earns it. The United States generally taxes that income currently. The foreign tax credit, discussed above, may reduce or eliminate the U.S. tax on that income, however.

Indirect operations—generally tax deferral

The other set of rules applies to U.S. persons that conduct foreign operations through a foreign corporation. In general, a U.S. shareholder of a foreign corporation pays no U.S. tax on the income from those operations until the foreign corporation sends its income home to America (repatriates it). The income appears on the U.S. owner's tax return for the year it comes home, and the United States generally collects the tax on it then. The foreign tax credit may reduce or eliminate the U.S. tax, however. (The foreign corporation itself will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.)

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, an actual dividend payment ends deferral: any U.S. recipient must include the dividend in income. Second, in the case of a controlled foreign corporation, an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a sale of shares of a foreign corporation triggers tax, sometimes at ordinary income rates (sec. 1248 or sec. 1246).

Indirect operations—current tax for some income

Deferral is not available for certain kinds of income (referred to here as "subpart F income") under the Code's subpart F provisions. That is, when a U.S.-controlled foreign corporation earns subpart F income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats the U.S. shareholders as having received a current dividend out of the subpart F income. In this case, too, the foreign tax credit may reduce or eliminate the U.S. tax.

This subpart F income subject to current U.S. taxation consists of several kinds of income that are generally suited to tax haven operations. Subpart F income is generally income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income is not limited to those kinds of income, however. Subpart F income presently consists of income from the insurance of U.S. risks (defined in sec. 953), foreign base company income (defined in sec. 954), and certain income relating to international boycotts and illegal payments. Foreign base company income is itself subdivided into five categories. One major category is foreign personal holding company income. For subpart F purposes, foreign personal holding company income consists generally of passive income such as interest, dividends, gains from sales of stock and securities, related party factoring income, and some rents and royalties. Gains from certain commodities futures transactions are foreign personal holding company income unless they arise out of certain bona fide hedging transactions. An exclusion from foreign personal holding company income is provided for rents and royalties received from unrelated persons in the active conduct of a trade or business. Under this active trade or business test, rents from a retail car-leasing business involving substantial maintenance, repair, and marketing activities, for example, would be excluded from subpart F, while rental income from lease-financing transactions would not. Exclusions are also provided for dividends, interest, and gains derived from unrelated persons by a banking, financing, or similar business, and dividends, interest, and gains received by an insurance company from its investment of unearned premiums and reserves. Additional exclusions from foreign personal holding company income are provided for (1) certain dividends and interest received from a related person organized and operating in the same foreign country as the recipient, (2) interest paid between related persons that are each engaged in the conduct of a banking, financing, or similar business predominantly with unrelated persons, and (3) rents and royalties received from a related person for the use of property within the country in which the recipient was created or organized.

Other categories of foreign base company income include foreign base company sales and services income, consisting respectively of income from related party sales routed through the recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. (Income from the insurance of related parties' third-country

risks is taxed as foreign base company services income.) Foreign base company income also includes foreign base company shipping income, except to the extent such income is reinvested by the controlled foreign corporation in foreign shipping operations. Finally, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Income that would otherwise be subject to current taxation as foreign base company income may be excluded from subpart F under present law, if the taxpayer establishes that reducing taxes was not a significant purpose of earning the income through a controlled foreign corporation. The regulations implementing this rule provide objective tests that may be used to determine whether a controlled foreign corporation has been used to reduce tax. For example, the regulations provide that if foreign personal holding company income is subject to tax in the controlled foreign corporation's country of incorporation at an effective rate that is at least 90 percent of (or not more than five percentage points less than) the U.S. rate, then the controlled foreign corporation has not been used to reduce tax.

Reasons for Change

Overview

It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, the committee believes that a major motivation of U.S. persons in earning such income through foreign corporate vehicles often is the tax benefit expected to be gained thereby. The committee believes that it is generally appropriate to impose current U.S. tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of a foreign corporation. The committee believes that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices are placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.

In the committee's view, several of the exceptions to current taxation under subpart F are excessively broad under present law. The committee believes that those exceptions often inappropriately permit U.S. taxpayers to defer U.S. taxation of several types of income by earning such income through a foreign corporation. Deferral of U.S. tax on the foreign income of a U.S.-controlled foreign corporation generally is inappropriate when the corporation functions to shift income to a jurisdiction in which it generates tax benefits for the U.S. shareholders. In particular, the committee believes that the following types of income may sometimes be earned through a foreign corporation in a tax haven country that bears limited substantive economic relation to the income, and that continued deferral of U.S. tax on such income encourages the move-

ment of the associated operations abroad at the U.S. Treasury's expense.

Sales of property which generates passive income

Foreign personal holding company income that is subject to current U.S. taxation when earned by a controlled foreign corporation includes gains from the sale or exchange of stock or securities (except in the case of regular dealers). Thus, U.S. shareholders of a controlled foreign corporation are subject to current taxation not only on the dividends and interest generated by stock and securities, but also on the gain realized when such investment property is disposed of. However, under present law other investment property that generates income subject to current taxation under subpart F is not subject to current tax when disposed of. The committee believes that this inconsistency should be eliminated, and has concluded that a more logical approach is to impose current taxation upon the disposition of any property that gives rise to passive income that is currently taxed. Thus, for example, a controlled foreign corporation's disposition of a patent or license (not used in the active conduct of a trade or business) should constitute subpart F income subject to current U.S. taxation to the corporation's U.S. shareholders.

Commodities transactions

Foreign personal holding company income that is subject to current U.S. taxation when earned by a controlled foreign corporation includes gains from futures transactions in any commodity (with a hedging exception). The committee believes that the limitation of this rule to commodities futures transactions inappropriately excludes from subpart F gains realized by passive investors in commodities contracts other than futures contracts. The committee thus concludes that all income from commodities transactions should generally be subject to current U.S. taxation under subpart F. However, the committee recognizes that commodities transactions may constitute an integral part of the active business of a producer, processor, merchant, or handler of commodities. Just as many futures transactions of such persons are generally excluded from foreign personal holding company income (under the hedging exception), non-futures transactions of such persons should be excluded under a similar rule.

Foreign currency gains

Congress enacted subpart F in 1962 when currency exchange rates generally were fixed. Since the advent of floating exchange rates in the early 1970's, taxpayers have realized foreign currency gains and losses. The committee believes that income from trading in foreign currencies represents the type of income that can easily be routed through a controlled foreign corporation in a tax haven jurisdiction. Therefore, income from transactions in a foreign currency (including futures transactions) should generally be subject to current U.S. taxation under subpart F, unless directly related to the business needs of the corporation.

Banking and insurance income

Dividends, interest, and gains from sales of stock and securities are under present law generally treated as foreign personal holding company income that is subject to current taxation under subpart F. However, when such income is received from unrelated persons in the conduct of a banking, financing, or similar business it is not subjected to current taxation. Similarly, such income is excluded from foreign personal holding company income when it is derived from an insurance company's investments of unearned premiums, ordinary and necessary reserves, and certain other funds. The committee believes that these exceptions often provide excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere. The proliferation of U.S.-controlled banking and insurance companies in various tax haven jurisdictions suggests that many taxpayers are in fact taking advantage of the ability to earn dividends, interest, and gains through such entities, on which the U.S. tax is deferred and the foreign tax is often insignificant.

Because dividends, interest, and gains on the sale of stock and securities are inherently manipulable, it is inappropriate to allow continued deferral with respect to such income that is earned through a controlled foreign corporation, regardless of the nature of the business earning such income. Thus, dividends, interest, and gains from the disposition of stock or securities should be treated as foreign personal holding company income subject to current U.S. taxation under subpart F, regardless of whether the corporation receiving such income is engaged in a banking, financing, or insurance business.

Rents and royalties

Rents and royalties received in the active conduct of a trade or business from unrelated persons are not under present law treated as foreign personal holding company income. The committee is concerned that this rule may in some cases fail to prevent the use of a controlled foreign corporation for tax-avoidance purposes. In particular, this rule fails to prevent a U.S. taxpayer from routing rental or royalty income through a corporation in a country that has no substantive relation to the income. For example, a U.S. taxpayer can develop a patent, license that patent to a controlled Netherlands corporation, and then have the Netherlands corporation license the patent to its ultimate user in a third country. In this example, the Netherlands corporation has been interposed between the country in which the patent was developed and the country in which the patent will be used. The committee does not believe that such manipulations of income should be respected for U.S. tax purposes. A comparable transaction involving the sale of property or the provision of services through a controlled foreign corporation is presently subject to current taxation under the foreign base company sales and services rules of subpart F. The com-

mittee believes that the logic of those rules generally is as applicable to rental and royalty income as it is to sales or services income; in all three cases, current U.S. taxation should be imposed when income is earned through a corporation in a country that has limited substantive economic relation to the transaction. Thus, the committee has concluded that the current exception for active-business rents and royalties should be narrowed to prevent the use of a controlled foreign corporation as a conduit, under rules similar to those applicable to sales and services income. The committee does not believe that the statutory active trade or business test needs to be further modified, and the committee generally approves of the manner in which the test has been implemented by the Secretary under present law. In particular, the committee approves of treating rental income from transactions that are in substance financing arrangements as foreign personal holding company income. Lease-financing income generally represents the type of movable financial income that is intended to be subject to current taxation under subpart F.

Related person exceptions

Foreign personal holding company income presently does not include dividends and interest received from a related person organized and operating in the same foreign country as the recipient, interest paid between related persons engaged in the conduct of a banking, financing, or similar business, or rents and royalties received from a related person for the use of property within the country in which the recipient was created or organized. Thus, for example, interest paid by a sales subsidiary to a holding company organized in the same foreign country generally would not be treated as foreign personal holding company income. The exceptions for interest, rent, and royalty payments can be manipulated to avoid current U.S. taxation of tax haven income. For example, if one company in a group earns tax haven income, but pays interest to a related company in the same foreign country, the deduction for the interest may reduce the first company's tax haven income, but at the same time the interest is not considered tax haven income to the second company because of the same country interest exception. Thus, intercompany payments that benefit from the same country exceptions can reduce the total tax-haven income of a group of related companies. The committee therefore concludes that the above exceptions should be limited by a rule that looks through to the nature of the income earned by the payor. The committee believes that the related party banking exception should be repealed, consistent with the repeal of the general exemption for dividends, interest, and gains from sales of stock and securities derived from unrelated persons in a banking, financing, or similar business.

Shipping income

Foreign base company income subject to current taxation under subpart F does not, under present law, include foreign base company shipping income that is reinvested in foreign base company shipping operations. The committee does not believe that this reinvestment exclusion is appropriate as a matter of tax policy. No-

where else in subpart F is such an exception granted; in all other cases, if tainted income is earned through a controlled foreign corporation, then current taxation under subpart F applies, regardless of the use to which the income is put. Congress has made a judgment that shipping income is the inherently manipulable type of income rarely subjected to foreign tax that ought to be subject to subpart F when earned through a foreign corporation. The committee believes that as a matter of tax policy that judgment should be given full effect. Because shipping income is seldom taxed by foreign countries, earning such income through a foreign corporation can effectively exempt it from all current tax, U.S. and foreign. The present exclusion thus serves to promote U.S. investment in foreign-flag shipping operations by providing U.S. tax benefits to such investment. The committee questions whether it is fully in the interests of the United States to promote U.S. investment in the shipping activities of other nations.

The committee is also concerned that income earned in locations outside the jurisdiction of any country may, like shipping income, escape being currently taxed by any country. Examples of such income include income earned in space and on the ocean floor. The committee does not believe that U.S. persons should be able to defer all tax on such income for an indefinite period by earning it through a foreign corporation.

Insurance income

Income from the insurance of U.S. risks is under present law subject to current taxation under subpart F, as is income from the insurance of related persons' risks in countries outside the insurer's country of incorporation. The committee believes that income from the insurance of risks outside the insurer's country of incorporation should be subject to current taxation regardless of whether the risks are located in the United States and regardless of whether the insured is a related person. Insurance income generally represents the type of inherently manipulable income at which subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction. (Indeed, several countries promote themselves as jurisdictions for the formation of such corporations.) When a controlled foreign corporation insures risks outside of the country in which the corporation is organized, then it is appropriate to treat that income as if it has been routed through that jurisdiction primarily for tax reasons, regardless of whether the insured is a related or unrelated person. In all such cases, it is appropriate to impose current U.S. taxation under subpart F.

Income from a controlled foreign company's insurance of U.S. risks is excluded from subpart F under a present law de minimis rule if it accounts for less than 5 percent of the corporation's premium-type income. Such a rule is no longer appropriate in the context of a provision that taxes a controlled foreign corporation's income from the insurance of all risks outside the insurer's country of incorporation, whether those risks are located in the United States or in another foreign country. Furthermore, the committee is in general concerned that such exceptions tend to permit a large controlled foreign corporation to avoid subpart F treatment of

income of an otherwise-tainted kind that is quite substantial in absolute terms.

Exception for foreign corporation not used to reduce taxes

As indicated above, income that would otherwise be subject to current taxation as foreign base company income may be excluded from subpart F under present law, if the taxpayer establishes that reducing taxes was not a significant purpose of earning the income through a controlled foreign corporation. The regulations implementing this rule provide an objective test that may be used to determine whether a controlled foreign corporation has been used to reduce tax. The committee believes that such an objective test is preferable to the general subjective test now provided in the statute. An objective test provides greater certainty for both taxpayers and the Internal Revenue Service. The committee believes that "significant purpose" tests tend to involve taxpayers and the Service in prolonged disputes and litigation, since the correct result under such a rule is often difficult to determine. Although in some cases such an approach cannot be avoided, the committee believes that if movable types of income have been moved to a jurisdiction where they in fact bear a low rate of tax, then it is appropriate to impose current U.S. tax on such income without any inquiry into the subjective motivations of the taxpayer. Thus, taxpayers should be permitted to except income from current taxation under subpart F only by showing that such income is subject to foreign tax at a rate substantially equal to the U.S. rate.

The committee is aware that with respect to foreign base company sales and services income the regulations presently contain a rule that compares the tax paid in the controlled foreign corporation's country of incorporation with the lesser of the U.S. tax or the tax of the country in which such base company income is actually earned. The committee believes that such an approach adds substantial complexity and defeats the effort to provide certainty. The rule that looks to the rate of tax in the country of ultimate use of goods or services requires the determination of a hypothetical tax on a hypothetical tax base in that country.Thus, taxpayers (and the Service) are required not only to apply a third country's tax laws, but to do so on the basis of a purely hypothetical set of tax attributes (income, deductions, basis of assets, etc.) of a business in that country. The committee believes that application of such a rule on a broad scale would create severe enforcement difficulties, since the Service would be required to make the above determinations with respect to a large number of taxpayers claiming the benefits of such a rule. Furthermore, the rules of subpart F represent judgments that certain types of income are particularly prone to manipulation, and that earning such income through a foreign corporation is by itself enough to justify a presumption that the potential for tax avoidance is too great to permit continued deferral of U.S. tax. The committee does not believe that the presence or absence of foreign tax advantages is relevant to the validity of those judgments relating to avoidance of U.S. taxes, and that otherwise-applicable subpart F rules should generally apply regardless of foreign tax considerations. Therefore, the committee has concluded that it is appropriate to eliminate any comparison with a hypothet-

ical rate of tax in the country of ultimate use, and to rely instead on a comparison with the U.S. rate of tax in all cases.

Explanation of Provisions

Overview

The bill generally narrows the exceptions to subpart F income and adds to it certain other types of income that are particularly susceptible of manipulation. Thus, sales of property which generates passive income, commodities gains, and foreign currency gains are added to foreign personal holding company income. In addition, the bill repeals the exceptions for banking and insurance companies' income from interest, dividends, and dispositions of stock and securities. The exceptions for active business rents and royalties and for certain payments between related persons are subjected to new restrictions. The reinvestment exclusion for shipping income is repealed, and the scope of the insurance income subject to subpart F is broadened.

On the other hand, the committee recognizes that broadening the scope of current U.S. taxation under subpart F may in some cases affect the operations of U.S. taxpayers using foreign corporations for business rather than tax reasons. To minimize any such effect, the committee places increased reliance on the provision of existing law that excepts income from current taxation under subpart F if it was not in fact routed through a controlled foreign corporation with the purpose of avoiding tax. However, the bill replaces the subjective "significant purpose" test of present law with an objective test to determine whether income that has been earned through a controlled foreign corporation has in fact avoided tax.

Sales of property which generates passive income

The bill adds to the Code section 954(c) definition of foreign personal holding company income for subpart F purposes all gains from the sale or exchange of property that gives rise to dividends, interest, rents, royalties, and annuities which constitute foreign personal holding company income. Thus, for example, gain from the disposition of property giving rise to same country active business rents and royalties would not be treated as foreign personal holding company income under this rule, since the property disposed of did not itself give rise to such income (pursuant to present section 954(c)(3)(A) as amended by the bill). The present law exception for regular dealers will continue to apply to this broader category of transactions.

Commodities transactions

The bill adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes gain from any transaction (including a futures transaction) in any commodity. The bill retains the present law exception for gains by a producer, processor, merchant or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. An additional exception is provided for transactions (not limited to hedging transactions) that occur

in the active business of a corporation substantially all of whose business is that of an active producer, processor, merchant, or handler of commodities. The committee intends this exception to apply only to corporations actively engaged in commodities businesses, not those primarily engaged in such financial transactions as the trading of futures. Taking delivery of physical commodities will generally indicate the existence of such a business, but such activity will not of itself be determinative of the issue. For example, the business of a company that trades primarily in precious metals may be essentially financial, particularly if the company takes delivery of the metals through an agent such as a bank.

Foreign currency gains

The bill adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes gain attributable to any transaction (including a futures transaction) in a foreign currency (other than the taxpayer's applicable functional currency). However, such treatment will not apply to hedging and other transactions that are directly related to the business needs of a controlled foreign corporation.

Banking and insurance income

The bill imposes current tax on all foreign personal holding company income earned by banks and insurance companies, subject to the exclusion for high-taxed income described below. The bill does so by repealing the rules that presently exclude from foreign personal holding company income for subpart F purposes dividends, interest, and gains from the sale or exchange of stock or securities received from unrelated persons either in the active conduct of a banking, financing, or similar business, or from an insurance company's investment of unearned premiums, reserves, and certain other funds (section 954(c)(3)(B) and (C)). Thus, dividends, interest, and gains received from unrelated persons by a controlled foreign bank or insurance company will constitute foreign personal holding company income taxable currently to the U.S. shareholders of the corporation. In addition, the bill repeals the rule that presently excludes from foreign personal holding company income for subpart F purposes interest paid by a related person to a controlled foreign corporation if both are engaged in a banking, financing or similar business (section 954(c)(4)(B)).

However, it should be noted that other provisions of the bill limit the effect of the elimination of the exceptions for banking, financing, and insurance companies. First, the rule which provides an exception for income that is subject to substantial foreign taxes will frequently exempt income derived by a controlled foreign corporation from financial operations in non-tax haven countries from current taxation under subpart F. Thus, interest, dividends, and gains that a controlled foreign banking business derives from operations in most major trading partners of the United States (which tend to tax such income at effective rates equal to or greater than the U.S. rate) will not be treated as foreign personal holding company income notwithstanding the bill's elimination of the general exception for banking and financing businesses. Thus, the elimination of that exception will impose current tax only on income of controlled

foreign banks and insurance companies that is in fact received in low-tax jurisdictions.

Second, income of any kind received by an offshore insurance company, including income derived from its investments of funds, will generally be subject to taxation under section 953, as described below. Regulations under present law specify that taxation of an insurance company's income under section 953 takes precedence over its treatment as foreign personal holding company income. Thus, dividends, interest, and gains derived by a controlled foreign insurance company will not generally be treated as foreign personal holding company income in any event, if they are instead taken into account under section 953.

Rents and royalties

The bill adds a restriction to the rule that under present law generally excludes from foreign personal holding company income for subpart F purposes rents and royalties received from unrelated persons in the active conduct of a trade or business (section 954(c)(3)(A)). Under the new restriction, a rent or royalty will not qualify for the exclusion if it is both attributable to property developed, produced or acquired by a related person outside the controlled foreign corporation's country of incorporation, and received for the use of such property outside of that country. Thus, active business rents and royalties will be subject to current taxation under subpart F if they are routed through a controlled foreign corporation in a country where the leased or licensed property was neither developed (or acquired) nor used.

Related person exceptions

The bill adds a restriction to the rules that under present law exclude from foreign personal holding company income for subpart F purposes certain dividends, interest, rents, and royalties received from related persons (section 954(c)(4)(A) and (C)). (Section 954(c)(4)(B), relating to interest paid between related banks, is repealed by the bill. See discussion of banking and insurance income, above.) Under the new restriction, interest, rent, and royalty payments will not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor. Thus, if the income of the payor corporation consists entirely of non-subpart F income, then the related party exclusions of section 954(c)(4)(A) and (C) will apply in full as under present law. However, to the extent that the payor corporation receives subpart F income which is reduced by its payment of interest, rent, or royalties, then such payment will be treated as subpart F income to a related party recipient, notwithstanding the general rules of section 954(c)(4).

Shipping income

The bill repeals the rule that under present law excludes from foreign personal holding company income for subpart F purposes foreign base company shipping income that is reinvested in foreign base company shipping operations (section 954(b)(2)). Thus, any income that constitutes foreign base company shipping income under section 954(f) will be subject to current taxation under subpart F, regardless of the controlled foreign corporation's use of the

income. In addition, the bill adds to the definition of foreign base company shipping income any income derived from activities outside the jurisdiction of any country, including generally income derived in space, in the ocean, or in Antarctica.

Insurance income

The bill expands Code section 953's definition of insurance income that is subject to current taxation under subpart F. Subpart F will apply to any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized. In addition, subpart F will apply to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks. The amount of income subject to tax under subpart F is the amount that would be taxed under subchapter L of the Code if it were the income of a domestic insurance company (subject to the modifications provided in section 953(b)). Finally, the bill repeals the de minimis rule of section 953(a), which excludes income from the insurance of U.S. risks that is otherwise subject to subpart F if it constitutes 5 percent or less of the total premium-type income of an insurance company. Thus, any income of a controlled foreign corporation from the insurance of risks located in other countries will be subject to current taxation under subpart F, in accordance with the provisions of subchapter L (as modified). The alternative definition of a controlled foreign corporation provided in Code sec. 957(b) for purposes of taking into account insurance income described in sec. 953(a) will continue to apply with respect to section 953 as amended by the bill. Under the alternative definition, a foreign corporation is considered a controlled foreign corporation if more than 25 percent of its voting power is owned by U.S. shareholders.

Exception for foreign corporation not used to reduce taxes

The bill modifies the rule of section 954(b)(4), which excludes non-tax avoidance income from current taxation under subpart F, by replacing present law's subjective "significant purpose" test with an objective rule. Under the new rule, subpart F income does not include items of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary that the income was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum corporate tax rate (36 percent under the bill). However, this exception to subpart F does not apply to foreign base company oil-related income described in section 954(a)(5).

Although this rule applies separately with respect to each "item of income" received by a controlled foreign corporation, the committee expects that the Secretary will provide rules permitting reasonable groupings of items of income that bear substantially equal effective rates of tax in a given country. For example, all interest income received by a controlled foreign corporation from sources within its country of incorporation may reasonably be treated as a

single item of income for purposes of this rule, if such interest is subject to uniform taxing rules in that country.

The committee intends, by making the operation of this rule more certain, to ensure that it can be used more easily than the subjective test of present law. This is important because it lends flexibility to the committee's general broadening of the categories of income that are subject in the first instance to current tax under subpart F. The committee's judgment is that because moveable income could often be as easily earned through a U.S. corporation as a foreign corporation, a U.S. taxpayer's use of a foreign corporation to earn that income may be motivated primarily by tax considerations. If, however, in a particular case no U.S. tax advantage is gained by routing income through a foreign corporation, then the basic premise of subpart F taxation is not met, and there is little reason to impose the subpart F tax. Thus, since the scope of transactions subject to subpart F will be broadened, and may sweep in a greater number of non-tax motivated transactions, the committee expects that the flexibility provided by a readily applicable exception for such transactions will become a substantially more important element of the subpart F system.

Effective Date

The above changes apply for taxable years of foreign corporations beginning after December 31, 1985.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $132 million in 1986, $228 million in 1987, $223 million in 1988, $244 million in 1989, and $270 million in 1990.

2. Thresholds for Imposition of Current Tax Under Subpart F

a. Determination of U.S. control of foreign corporation (sec. 622 of the bill and secs. 552 and 957 of the Code)

Present Law

The provisions of subpart F, which impose current tax on foreign corporate earnings, apply only to controlled foreign corporations. A corporation is a controlled foreign corporation only if more than 50 percent of the voting power of the corporation belongs to U.S. persons that each own at least 10 percent of the voting power. Similarly, the foreign personal holding company rules (Code sections 551-58), which also impose current U.S. tax on some foreign corporate investment income, apply only if more than 50 percent of the value (as opposed to voting power) of the corporation belongs to five or fewer U.S. individuals.

Reasons for Change

The committee is concerned that the present controlled foreign corporation rules can be manipulated by taxpayers to avoid the provisions of subpart F. Since U.S. control is defined solely in terms of voting power, taxpayers can structure their investments to avoid subpart F by ensuring that they hold no more than 50 percent of the voting power of a corporation, even when they hold the majority of the value of the corporation in the form of nonvoting stock. The committee notes that Congress amended the consolidated return rules in 1984 to consider both vote and value because of a similar concern that taxpayers could manipulate a single factor test. Also, Congress mandated vote or value tests for the provisions of the 1984 Act that maintain the character and source of income earned by U.S.-owned foreign corporations and those that extend application of the accumulated earnings tax to U.S.-owned foreign corporations.

The committee is also concerned that because subpart F applies only if more than 50 percent of a foreign corporation is U.S.-controlled, U.S. shareholders can avoid subpart F without giving control of a corporation to foreign shareholders simply by dividing voting power evenly between U.S. and foreign shareholders.

The committee believes that the foreign personal holding company rules are similarly subject to manipulation, since they rely on a single-factor (value) greater-than-50 percent test.

Explanation of Provision

The bill amends the definition of a controlled foreign corporation (Code section 957(a)) to provide that subpart F will apply to the U.S. shareholders of a foreign corporation if 50 percent or more of

either the voting power or the value of the stock of the corporation is owned by U.S. persons that each own at least 10 percent of the vote on any day during the taxable year of the foreign corporation. Similarly, the foreign personal holding company rules will apply if 50 percent or more of either the voting power or the value of a foreign corporation belongs to five or fewer U.S. individuals.

Effective Date

The provision generally applies for taxable years of foreign corporations beginning after December 31, 1985. However, for a taxable year of a foreign corporation beginning during 1986, control will be determined on the basis of the present law "more than 50 percent" rule, rather than "50 percent or more."

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $16 million in 1986, $32 million in 1987, $33 million in 1988, $34 million in 1989, and $40 million in 1990.

b. Definition of related person (sec. 621 of the bill and sec. 954 of the Code)

Present Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. In general, a related person for purposes of subpart F is defined (in Code section 954(d)(3)) as an individual, partnership, trust, or estate which controls the foreign corporation, a corporation which controls or is controlled by the foreign corporation, or a corporation which is controlled by the same persons that control the foreign corporation. Thus, a partnership, trust, or estate in which the controlled foreign corporation holds an interest is not considered a related person under this definition.

For purposes of the above rules, control of a corporation is defined as the direct or indirect ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Reasons for Change

The committee believes that the exclusion of a controlled partnership, trust, or estate from the subpart F definition of a related person is without logical support. Income that would be treated as subpart F income of a controlled foreign corporation if received from a subsidiary corporation can avoid such treatment simply by being routed through a controlled partnership instead.

In addition, the committee is concerned that defining related persons in terms of greater than 50-percent control makes it relatively easy to avoid related person status, and thus possibly to avoid subpart F. This is so because related person status with respect to any given entity or group of entities can be avoided without giving control of the entity or group to other persons, by dividing voting

power evenly between the parties. Since only voting power is tested, this is true even if the majority of the value of the corporation is held by one party in the form of nonvoting ownership interests.

Explanation of Provision

The bill expands the definition of related person in Code section 954(d)(3) to include a partnership, trust, or estate which controls, or is controlled by, the foreign corporation, as well as a partnership, trust, or estate which is controlled by the same persons that control the foreign corporation.

In addition, the bill amends the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1985.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by less than $10 million per year.

c. *De minimis tax haven income rule* (sec. 623 of the bill and sec. 954 of the Code)

Present Law

The subpart F rules that impose current U.S. tax on income of controlled foreign corporations apply only to certain types of income. One major category of income that is subject to current taxation under subpart F is foreign base company income. Foreign base company income includes passive investment income and certain sales, services, shipping, and oil related income. A de minimis rule in subpart F provides that if less than 10 percent of a foreign corporation's gross income is base company income, then none of the income will be treated as base company income. On the other hand, if more than 70 percent of a foreign corporation's gross income is base company income, then all of its income will be treated as base company income.

Reasons for Change

The committee is concerned that application of the 10-percent de minimis rule (and the 70-percent rule) on the basis of gross income allows taxpayers to earn substantial amounts of tax haven gross income (such as interest) which is offset by few expenses, and yet not fail the 10-percent test (or the 70-percent test) if they also earn substantial non-tax haven gross income, even if that other income is largely offset by expenses. For example, assume a manufacturing

business generates gross income of $1,000 and net income of $200. Applying the subpart F de minimis rule on a gross income basis allows the corporation to earn $100 of tax haven gross income (10 percent of $1,000) without being subject to subpart F. If this gross tax haven income is offset by very few expenses (e.g., a bank account may generate equal amounts of gross and net income), the $100 of tax haven gross income would represent fully a third of the corporation's net income, but still benefit from the "de minimis" rule excluding it from subpart F. This would be true even if tax haven income constituted 100 percent of the corporation's net income, as long as it did not exceed 10 percent of gross income.

The committee believes that the exception from subpart F for de minimis amounts of tax haven income should be applied on the basis of earnings and profits to avoid distortions of the type just described; a corporation should not be excepted from subpart F when all or a substantial portion of its net income is tax haven income. The committee is satisfied that a rule based on earnings and profits is administrable, as most taxpayers must now calculate earnings and profits of their foreign subsidiaries in any event.

Explanation of Provision

Under the bill, if less than 10 percent of a controlled foreign corporation's earnings and profits are foreign base company income, then none of its income will be treated as base company income. If more than 70 percent of a controlled foreign corporation's earnings and profits are base company income, then all of its income will be treated as such.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1985.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $19 million in 1986, $33 million in 1987, $33 million in 1988, $37 million in 1989, and $39 million in 1990.

d. *Possessions corporations* (sec. 624 of the bill and sec. 957 of the Code)

Present Law

A corporation chartered in the possessions is not considered a controlled foreign corporation if (1) at least 80 percent of the corporation's gross income is from sources within a possession, and (2) at least 50 percent of the corporation's gross income is from the active conduct of a manufacturing, processing, fishing, mining, or hotel business. Thus, the tax-haven type (subpart F) income of such corporations is not taxed currently to controlling U.S. shareholders. This provision was enacted in 1962 in conjunction with the enactment of subpart F, and was intended to promote investments in active businesses in the possessions.

Reasons for Change

The committee believes that the exemption from controlled foreign corporation status available to possession-chartered corporations is poorly targeted to the creation of employment-producing investments in the possessions. The exemption of tax haven income from current taxation under subpart F would not appear to provide incentive for the type of substantial economic activity that is needed to promote employment and economic development in the possessions.

Explanation of Provision

The exemption from controlled foreign corporation status available to possession-chartered corporations is repealed. Thus, U.S. shareholders of possessions corporations will be treated like U.S. shareholders of other foreign corporations, so they will be subject to current U.S. tax under subpart F on tax haven-type income of the corporations.

Effective Date

The provision generally applies for taxable years of foreign corporations beginning after December 31, 1985. However, deficits in earnings and profits for taxable years beginning before 1986, and, for purposes of Code section 956, property acquired before 1986, shall not be taken into account with respect to corporations that become subject to subpart F because of the repeal of the exemption for possessions corporations.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by less than $10 million per year.

3. Taxation of Foreign Investment Company Income (Sec. 625 of the bill and sec. 1246 and new sec. 1246A of the Code)

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation only on their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income.

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" or other type activities conducted by corporations

controlled by U.S. shareholders is currently taxed to the corporation's U.S. shareholders without regard to whether they actually receive the income under present law in the form of a dividend. However, these subpart F rules apply only if more than 50 percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least 10 percent interests in the corporation. Moreover, even if ownership is so concentrated that the subpart F rules apply, the rules apply only to those U.S. persons who are considered to own 10 percent or more of the voting power in the foreign corporation. Thus, a less than 10-percent shareholder in a controlled foreign corporation can avoid current recognition of income under these provisions.

Two other similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer individuals own (directly or indirectly) more than 50 percent in value of the stock of a foreign corporation. Thus, these provisions may be avoided by dividing ownership evenly between U.S. and foreign persons or by dispersing ownership among more than five U.S. persons.

Shareholder level tax on disposition

Code rules attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower capital gains rates after deferring tax on those earnings. Gains derived by a U.S. person who is a 10-percent shareholder (at any time during a five-year period) in a controlled foreign corporation (defined as in the subpart F rules) on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (Code sec. 1248).

Wide dispersal of a foreign corporation's stock ownership can avoid controlled foreign corporation status. Even if the foreign corporation is controlled by U.S. shareholders, a less than 10-percent shareholder may dispose of his investment and potentially receive capital gain treatment for the increase in value of his investment.

Another provision, the foreign investment company provision (sec. 1246), was enacted in 1962 along with the subpart F rules to prevent U.S. investors from receiving capital gains treatment when U.S. ownership in the foreign corporation was dispersed among more than five U.S. persons but total U.S. ownership exceeded 50 percent and the foreign corporation primarily invested in securities. Specifically, the provision generally applies to any U.S.-owned foreign corporation that is either (1) registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust or (2) engaged primarily in the business of investing or trading in securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or commodities or interests therein. Such a foreign investment company is subject to this provision if 50 percent or more of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent

of his share of the foreign investment company's accumulated earnings and profits, but not to exceed the person's gain on the disposition.

Under present law, sections 1248 and 1246 may apply to the same factual situation. For example, if a controlled foreign corporation has a 10-percent owner and the corporation is in the business of investing in securities, both provisions may potentially apply in the event the 10-percent owner disposes of his stock. Under present law, section 1246 is considered to take priority. Since an inclusion under section 1248 may bring with it a deemed-paid credit for taxes paid by a foreign corporation but a section 1246 inclusion will not, the deemed-paid foreign tax credit is not available in such circumstances.

Reasons for Change

The committee does not believe that U.S. persons who invest in passive assets should be able to avoid current taxation just because they invest in those assets indirectly through a foreign corporation. The committee does not believe that the foreign nationality of the majority of the shareholders of a foreign corporation that primarily invests in passive assets should shield U.S. shareholders from current taxation. Furthermore, the committee does not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make foreign investments. The committee is informed that foreign investment companies sometimes intentionally limit U.S. ownership so that it will not approach the 50-percent threshold. Thus, U.S. shareholders are currently able to circumvent the foreign investment company provision, avoid current recognition of income, and obtain capital gain treatment for income that would be ordinary income if received directly or received from a domestic investment company. The committee does not believe that U.S. taxpayers who choose to make passive investments through foreign companies should obtain these substantial U.S. tax advantages, regardless of whether the chosen investment company is controlled by U.S. or foreign taxpayers. In the committee's view, the absence of U.S. control does not require continued deferral of U.S. taxation of investment income earned through a foreign corporation. The committee does not believe that control of a corporation, and its theoretical ability to force a distribution of earnings, should always control the determination of whether it is appropriate to require shareholders' current recognition of a corporation's income. The theoretical ability to force a distribution from a controlled corporation is irrelevant because the immediate and effective control of income is not a prerequisite to its recognition. Thus, the provisions of subpart F already require current recognition of certain insurance income earned through a foreign corporation when U.S. shareholders own a less than controlling interest in the corporation (a 25 percent U.S. ownership threshold is sufficient under sec. 957(b)). Further, the provisions regarding original issue discount obligations require that a certain amount of interest income be recognized each year. The owner of the obligation receives the interest only if he holds the obligation to maturity or disposes of it. As another example, regulated futures contracts are taxed on a mark to

market basis regardless of whether the investor liquidates his investment. The committee also understands that other countries such as the Federal Republic of Germany and the Netherlands require current recognition of certain income from investments in offshore investment funds regardless of whether the investors receive distributions from the funds. Thus, the committee concludes that U.S. investors' limited ownership of a foreign corporation should not always preclude current U.S. taxation of income earned by the corporation.

However, the committee recognizes that in some cases taxpayers required to recognize investment income currently may not be easily able to pay the resulting tax liability. Therefore, although the committee believes that current recognition of income should be required of all U.S. investors in passive foreign investment companies, the committee also believes that the payment of tax on such income should be permitted to be deferred, at the taxpayer's election, subject to the payment of interest on the deferred amount. Thus, taxpayers could meet their tax liability at the time that they disposed of their interest or received a distribution of the income from the corporation. Present law contains similar provisions on certain types of deferred income (income earned through foreign trusts, sec. 668, and interest-charge DISCs, sec. 995).

In addition, the committee understands that under present law, a U.S. investor may never be fully taxed on his share of a foreign investment company's accumulated earnings and profits. The committee notes that if such income were generated by a domestic investment company or were received directly, the U.S. investor would have been taxed on the full amount of the income. The committee does not believe that a U.S. investor's share of ordinary income in a passive investment company should be reduced in the event that current earnings are not distributed. The committee believes that it can correct this inequity by requiring the total amount of a U.S. investor's share of ordinary income to be recognized, regardless of whether the investor's liquidating distributions are less than that amount.

The committee also does not believe that the 50 percent ownership requirement contained in present law should be relevant in allowing U.S. taxpayers to convert into capital gains income that would be ordinary if earned directly or through a domestic investment company. In the committee's view, the fact that ownership constituting control may be held by foreign persons should not change the character of income realized by a U.S. taxpayer.

Explanation of Provision

The bill makes two significant changes affecting foreign investment companies. First, the bill eliminates the 50-percent U.S. ownership requirement contained in present section 1246. Thus, a foreign investment company for this purpose is any foreign corporation which is (1) registered under the Investment Company Act of 1940, either as a management company or a unit investment trust, or (2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, com-

modities, or interests therein. The definition of securities is retained as under present law.

Another change made to the present foreign investment company rules of section 1246 is that, in the event both Code sections apply, the application of section 1246 is to yield to the application of section 1248 for purposes of allowing deemed paid foreign tax credits to 10-percent U.S. corporate shareholders. The application of section 1248 is intended to be only for this purpose and does not affect the operation of the new passive foreign investment company provisions described below.

The second significant change by the bill requires current recognition of income for U.S. persons who own stock in a newly defined category of foreign investment company, a passive foreign investment company. To accomplish this result, the bill adds a new section 1246A to the Code.

The new passive foreign investment company is defined by the bill to mean any foreign investment company where 75 percent of its gross income consists of passive income or any foreign investment company where 50 percent of its assets consist of assets that produce, or are held for production of, passive income. For example, stock paying no dividends currently but potentially able to pay dividends in the future is intended to be a passive asset for this purpose. Passive income is defined by the bill to mean income that is includible in the new passive income separate foreign tax credit limitation provided in section 601 of the bill (new Code sec. 904(d)(2)(A)). Thus, passive income includes portfolio dividends, interest, passive rents and royalties, gains from the disposition of stocks and securities, certain gains from commodity trading, and certain foreign currency exchange gains. Because the bill aligns this definition of passive income with the income that is in the new passive income foreign tax credit limitation, interest, dividend, and royalty income earned by foreign holding companies from 10-percent owned foreign companies engaged in certain active businesses, income earned by banks and insurance companies, and income earned by other active companies are not generally to be treated as passive income for purposes of this provision as long as such income is not includible in the passive income foreign tax credit limitation.

The bill provides that a passive foreign investment company is deemed to be a controlled foreign corporation, and that all U.S. persons who own stock in the company are deemed to be U.S. shareholders (whatever the level of their stock ownership). Thus, if a foreign corporation is a passive foreign investment company, the pro rata share of its subpart F income or of its increase in earnings invested in U.S. property attributable to its U.S. shareholders is deemed distributed to such shareholders. The committee intends that, where appropriate, other provisions of subpart F of the Code are to apply (except for the determination of status as a controlled foreign corporation or a U.S. shareholder) for purposes of imputing income to the passive foreign investment company's U.S. owners. For example, the income deemed distributed to U.S. investors is to be treated as previously taxed income when actually distributed, a deemed distribution to a direct 10-percent corporate U.S. investor is intended to include the investor's share of foreign taxes paid by

the company (while a deemed distribution to a less than 10-percent shareholder is not intended to include an investor's share of foreign taxes) and the new de minimis rule and 70 percent rule of section 954(b)(3) are to apply. In addition, the bill provides that the look-through rules of sec. 958(a) are to apply to prevent interposing tiers of foreign entities in order to circumvent current recognition of income by the U.S. shareholders.

Recognizing, however, that the U.S. shareholders subject to these provisions may sometimes not effectively control the passive foreign investment company and thus might be faced with liquidity problems by the current imposition of the tax, the bill provides that a U.S. investor in a passive foreign investment company can elect to defer current recognition of its share of the company's earnings and profits (but not of its share of the increase in earnings invested in U.S. property) by agreeing to pay, in addition to U.S. tax on that amount, an interest charge on the deferred tax. Receipt of the deferred income is considered to occur for this purpose when the U.S. investor receives a distribution (including a constructive distribution under sec. 956), or pledges or disposes of his investment. The bill makes it clear, however, that the election is available only to shareholders of a passive foreign investment company who are not otherwise U.S. shareholders of a controlled foreign corporation.

In the event a U.S. investor elects to defer current recognition of income, the bill provides that the interest charge is to be computed at the rate prevailing in Code section 6621(a) (the compounded interest rate generally applied with respect to underpayment of tax) from the due date (without regard to extensions) of the U.S. investor's return for the taxable year in which the deferred income arose to the due date (without regard to extensions) of the U.S. investor's return for the taxable year in which the investor receives a distribution or pledges or disposes of his investment. The interest charge is to be computed by multiplying the applicable compounded interest factor by the amount of the distribution times the highest marginal tax rate of the U.S. investor for the year in which it receives a distribution. The bill also provides that distributions are deemed to be out of the earliest years' earnings attributable to the U.S. investor (i.e., a first in, first out basis). The committee intends that the interest charge is to be interest subject to the deductibility limitations that apply to investment interest under section 163(d)(3)(D).

The bill also provides that in the event a U.S. investor in a passive foreign investment company elects to defer current recognition of income, no gain limitation of the type contained in section 1246(a) applies. Thus, a U.S. investor who elects deferral is subject to tax on its full pro rata share of the passive foreign investment company's deferred income on disposition of his investment. The bill further provides that the interest charge is computed with respect to the total amount of deferred income. In the event that the pro rata share of deferred income of a U.S. investor who elects deferral exceeds the amount of gain subsequently realized on the U.S. investor's disposition of his interest, the committee intends that a capital loss will result for that excess at the time of such disposition. This treatment is to accord with the committee's belief that a

U.S. investor should be subject to tax on the same amount of ordinary income as if the earnings had been currently distributed.

The bill provides that the election available to the U.S. investor is to be made in the investor's original return for the first taxable year in which it acquires its investment. The election is to be made by making an affirmative statement in the return that the investor elects to defer current recognition of its share of income of the passive foreign investment company. The election is only revocable with the consent of the Internal Revenue Service and is binding until the investor disposes of its entire investment in the company.

As indicated above, when a U.S. investor disposes of his investment in a passive foreign investment company, the U.S. investor is subject to tax on his entire share of the company's earnings and profits under new section 1246A, i.e., no gain limitation of the type contained in section 1246(a) applies. In this instance, it is intended, however, that a 10-percent corporate investor be allowed a deemed paid foreign tax credit.

Effective Date

The provisions are effective for taxable years of foreign corporations beginning after December 31, 1985. In the event a foreign corporation becomes a foreign investment company by reason of the bill's amendments, the foreign corporation's earnings and profits for taxable years beginning before December 31, 1985 are not to be taken into account for purposes of section 1246. For passive foreign investment companies, the rule requiring current recognition of income applies to earnings and profits generated in taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $10 million in 1986, $18 million in 1987, $17 million in 1988, $19 million in 1989, and $21 million in 1990.

D. Special Tax Provisions for U.S. Persons

1. Modifications to Possession Tax Credit (Sec. 641 of the bill and secs. 934 and 936 of the Code)

Present Law

Law Prior to 1976

Special provisions for the taxation of possession source income were first enacted in the Revenue Act of 1921. These provisions were adopted primarily to help U.S. corporations compete with foreign firms in the Phillipines (then a U.S. possession), although in recent years most of the tax benefit is claimed by corporations located in Puerto Rico. Under the 1921 Act, qualified corporations deriving 80 percent or more of their income from U.S. possessions were exempted from income tax on their foreign source income. To qualify for the exemption, at least 50 percent of the corporation's income had to be derived from the conduct of an active trade or business (as opposed to passive investment income). Dividends paid to a U.S. parent from a qualified possession subsidiary were taxable, while liquidating distributions were tax-exempt. Since the Puerto Rican Industrial Incentives Act of 1948, most possessions subsidiaries have operated under a complete or partial exemption from Puerto Rican taxes. Thus, a U.S. subsidiary doing business in Puerto Rico could avoid both Federal and local tax by accumulating operating income until its grant of local exemption expired, and then liquidating into the mainland parent.

Tax Reform Act of 1976

Although the Phillipines ceased to be a U.S. possession in 1946, the special tax treatment of possessions corporations remained unchanged until the Tax Reform Act of 1976.[1] In 1976, Congress indicated that Federal tax exemption had played an important role in Puerto Rican economic development. In the Finance Committee Report accompanying the 1976 Act,[2] the purpose of the special tax treatment of possession-source income was said to be "[to] assist the U.S. possessions in obtaining employment producing investment by U.S. corporations". The need for special tax incentives was attributed, in part, to the additional costs imposed by possessions status, such as the U.S. minimum wage standards and the requirement to use U.S. flag ships.

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[1] In 1954, these provisions were incorporated in sec. 931 of the Internal Revenue Code. Presently, the special tax rules apply to Puerto Rico, Guam, American Samoa, and the territories of Wake, Midway, and the Commonwealth of the Northern Mariana Islands. Separate, but similar, tax treatment applies to the U.S. Virgin Islands.

[2] Report of the Committee on Finance, United States Senate, on H.R. 10612, Sen. Rpt. 94-938 (June 10, 1976), p. 279.

It appeared that several features of the possession tax system had a high revenue cost with little corresponding benefit to employment or investment in the possessions. To avoid U.S. tax on dividends paid to a mainland parent, possession subsidiaries invested accumulated earnings from operations in foreign countries, either directly or through the Puerto Rican banking system. Thus, the benefits of the possession tax exemption were not limited to investments in the possessions.[3]

The 1976 Act added section 936 to the Internal Revenue Code, which altered the taxation of U.S. chartered possessions corporations. To more closely conform the tax treatment of possession income with the taxation of foreign source income, the exemption was converted to a credit. Thus, possession-source income was included in the definition of the possessions corporation's worldwide income. However, in lieu of the ordinary foreign tax credit (for income taxes paid to foreign governments) a tax credit was enacted (the possession tax credit) for the full amount of U.S. tax liability on possessions source income. This is referred to as "tax sparing" since a credit is granted whether or not foreign taxes are paid. Dividends repatriated from a possessions corporation qualify for the dividend-received deduction, which allows tax-free repatriation of possessions income.[4]

The 1976 Act defined qualified possession-source investment income ("QPSII") to include only income attributable to the investment of funds derived from the conduct of an active trade or business in the possessions. The intent was to provide tax benefits to investment income only when this income resulted from an active investment in the possessions. Income from investments in financial intermediaries, such as possession banks, was made eligible for the credit only if it could be shown that the intermediary reinvested the funds within the possession.

Tax Equity and Fiscal Responsibility Act of 1982

Despite the provisions in the 1976 Act, Congress in 1982 was concerned that the possession tax credit was costly and inefficient. According to the Finance Committee Report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA):[5] "Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of increased possession source investment income."

In addition, there was considerable disagreement under prior law regarding the extent to which intangible assets could be transferred to a possessions corporation free of U.S. tax. In July of 1980, the Internal Revenue Service issued Technical Advice Memorandum 8040019 which stated that intangibles transferred to a posses-

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[3] U.S. General Accounting Office, *Puerto Rico's Political Future: A Divisive Issue with Many Dimensions*, (March 2, 1981), GGD-81-48, p. 69.

[4] Companies eligible for the 100-percent dividend received deduction can repatriate possession-source income tax-free, while companies eligible for the 85-percent deduction are effectively taxed on 15 percent of possession-source dividends.

[5] Sen. Rept. No. 97-494, (July 12, 1982). pp. 81-2.

sion subsidiary at less than a reasonable arm's-length price did not belong to the subsidiary, and the income derived therefrom was allocable to the parent corporation rather than the subsidiary.

The 1982 Act addressed these issues by (1) increasing the active possession business income percentage requirement for possessions corporation status from 50 to 65 percent of gross income and (2) in effect denying the credit on intangible income of the possessions corporation. However, possessions corporations are permitted to derive some intangible income tax-free if they elect one of two optional methods of computing taxable income: (1) a cost sharing rule and (2) a 50/50 profit split. Under the former option, a possessions corporation is permitted to claim a return on manufacturing (but not marketing) intangibles in computing its income from products it produces, provided that it makes a (taxable) cost-sharing payment to its affiliates. The payment represents the possessions corporation's share of its affiliated group's worldwide direct and indirect research and development (R&D) expenditures in each product area in which the possessions corporation manufactures products subject to the cost sharing election. The possessions corporation's share of R&D expense is determined by reference to the ratio of third-party sales by members of its affiliated group of those products within a given product area which are produced in whole or in part by the possessions corporation to such sales of all products within that product area. The cost sharing payment effectively increases the taxable income of the possessions corporation's mainland affiliate and, consequently, its tax liability.

Under the 50/50 profit split election, the possessions corporation's taxable income (eligible for the credit) with respect to any product it produces in whole or in part is equal to 50 percent of the combined taxable income of the domestic members of its affiliated group with respect to covered sales of such product. The combined taxable income associated with a product is determined as the excess of gross receipts (on sales of the product to third parties) over the direct and indirect costs of producing and marketing the product. Thus, to the the extent that combined taxable income represents a return on intangible assets (both manufacturing and marketing intangibles), half of this intangible income is eligible for section 936 tax benefits. However, for purposes of computing the combined taxable income of which 50 percent is allocated to the possessions corporation, the amount of the group's R&D expenses allocated to income from the sale of a product generally cannot be less than a certain stated percentage of the cost-sharing payment that would have been required under the cost-sharing option.

To derive intangible income on a tax-free basis, the possessions corporation must make an irrevocable election to use one of the two options. A single option must be selected for all products within a product area.[6] In addition, neither option may be used for a product which does not meet the significant business presence test. A product satisfies this test if either (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions, or (2) at least 65 percent of the direct labor cost for

[6] Export sales within a product group are exempt from this requirement.

the product is incurred in the possessions. Finally, TEFRA generally prohibited possessions corporations from making future tax-free transfers of intangibles to foreign corporations.

Reasons for Change

The committee recognizes the importance of the possession tax credit to the possessions generally, and to Puerto Rico in particular. In addition, the committee understands that the Government of Puerto Rico is developing a "twin-plant" program to encourage companies with operations in Puerto Rico to develop or expand manufacturing operations in qualified Caribbean Basin Initiative ("CBI") countries. As a result of the twin-plant program, the committee anticipates that the continuation of the possession tax credit will promote economic development both in the possessions and in qualified CBI countries. Consequently, the bill retains the possession tax credit in a form substantially similar to present law, with several modifications designed to encourage more employment-producing investment per dollar of revenue loss to the Treasury. Also, the bill drops certain restrictions on the use of funds giving rise to qualified possession source investment income ("QPSII") to allow the Government of Puerto Rico to implement its initiative to promote economic development in CBI countries.

The annual Treasury reports on the operation of the possession tax credit indicate that the possession tax credit has been a relatively costly mechanism for creating employment. According to Treasury statistics, the possession tax credit amounted to over $22,000 per possessions corporation employee in 1982, more than 150 percent of the earnings of an average employee in that year ($14,210). Fourteen possessions corporations received tax credits in excess of $100,000 per employee in 1982.

Preliminary 1983 data indicate that the changes to the possession tax credit in 1982 reduced the amount of credits claimed by less than was anticipated in the revenue estimates accompanying TEFRA. In addition, these data show that while the effect of TEFRA was to reduce (by 29 percent) credits claimed by corporations that elected the 50/50 profit split method, TEFRA actually increased (by 2 percent) credits claimed by corporations that elected the cost sharing method. It appears that the difference between methods is attributable, in part, to defects in the cost sharing system which result in an inadequate allocation of income to affiliates of the possessions corporation. Problems with the cost sharing method may arise in situations where, for example, (1) possessions products fall outside the U.S. affiliates' main area of research or (2) the possessions corporation utilizes the U.S. affiliates' most valuable intangibles.

A significant portion of the possession tax credit is attributable to income generated from passive investments. Under present law, qualified possession source investment income may contribute up to 35 percent of the income of a possessions corporation eligible for the possession credit. As a result of this provision, and exemption from Puerto Rican tax, deposits of possessions corporations constitute over one-third of the commercial bank liabilities in Puerto

Rico.[7] Investment income is qualified for the credit only if it is derived from funds reinvested in the possessions for use therein. However, the Puerto Rican authorities have been concerned that these funds are being invested outside Puerto Rico (primarily in the Eurodollar market). The Puerto Rican Treasury Department issued regulations in 1980 and in 1984 that seek to prevent these funds from flowing out of Puerto Rico, but it remains unclear the extent to which these deposits have increased physical investment in Puerto Rico.

As a result of the uncertainty about the extent and nature of the investment stimulated by the credit for possession-source investment income, the committee believes that requiring possessions corporations to derive a larger fraction of their income directly from the conduct of an active trade or business will better achieve the objectives of creating employment-producing investment in the possessions. Moreover, the committee does not believe, in view of the volume caps on industrial development bonds adopted in the Tax Reform Act of 1984, that it is appropriate for the possessions to be able, in effect, to issue unlimited private purpose tax exempt bonds to U.S. investors.

Under present law, the possession tax credit is denied for otherwise eligible income if receipt occurs in the United States. The bill deletes the U.S.-receipt rule because in certain situations where payment must be received in the United States (e.g., certain defense contracts), the rule may discourage production in the possessions.

Explanation of Provision

The bill retains the possession tax credit as amended in TEFRA, with five principal modifications.

First, the cost sharing payment required for companies that elect the cost sharing option is set equal to the greater of (1) 110 percent of the payment required under present law, and (2) the royalty payment that would be required (under sections 482 and 367 as clarified by the bill) if the possessions corporation were treated as a foreign company (with respect to manufacturing intangibles the possessions corporation is treated as owning under the cost-sharing option). For purposes of the cost sharing option, the changes made by the bill to sections 367 and 482 would apply for taxable years beginning after December 31, 1985 to manufacturing intangibles which the possessions corporation is treated as owning under that option, regardless of when or whether such intangibles were ever actually transferred to the possessions corporation. For companies that elect the 50/50 profit split method, the amount of product area research expenditures (as determined under the cost sharing rules) would be increased by 20 percent for purposes of computing combined taxable income. Under present law, combined taxable income of U.S. affiliates for any product is computed by deducting from gross receipts (from sales to foreign affiliates and unrelated parties), the total costs incurred by U.S. affiliates with respect to the

[7] Under the Puerto Rican Industrial Incentives Act of 1978, income derived from a business operating under a tax-exemption grant may be reinvested free of Puerto Rican tax in certain assets, including term deposits in qualifying Puerto Rican banks.

product. For purposes of determining the combined taxable income of which 50 percent is allocated to the possessions corporation, the amount of research expense allocated to the product may not be less than the portion of the appropriate share of product area research expenditures (as determined under the cost sharing rules, applied without regard to the changes made by this bill other than the 20 percent increase in product area research expenditures) allocable to the product under a ratio set out in the profit split provisions.

For example, under present law, if product area research expenditures allocable to the product are $10 for a taxable year, then at least $10 of research cost must be taken into account in computing the product's combined taxable income for that taxable year. The bill would require that at least $12 (120 percent of $10) of research cost be taken into account in computing the product's combined taxable income. Consequently, the combined taxable income from sales of the product would be reduced by at most $2 ($12 minus $10) by virtue of this change, and the amount of income allocable to members of the affiliated group other than the possessions corporation under the 50/50 option, would be increased by at most $1 (50 percent of $2).[8]

Second, the bill changes the active trade or business test that a U.S. corporation must meet to qualify for the possession tax credit. Under present law, 65 percent or more of a possessions corporation's gross income for the three-year period immediately preceding the close of the taxable year must be derived from the active conduct of a trade or business in the possession. Under the bill, the active income percentage would increase from 65 percent to 70 percent for tax years beginning in 1986, and to 75 percent for tax years beginning after 1986. The bill does not alter the present law requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. As under present law, a possessions corporation must meet both the 80-percent possession source income test and the active trade or business test.

Third, the bill deletes the rule in present law (sec. 936(b)) which denies the credit with respect to income received in the United States (not including possessions thereof). As a result, the credit would not be denied for tax on otherwise eligible income solely by reason of receipt in the United States.

Fourth, the committee intends that the Commissioner may require the submission, with the tax return, of information relevant to section 936 tax computations. The Commissioner is authorized to require taxpayers to, *inter alia*, (1) identify all standard industrial classification ("SIC") codes to which research expenses relate; (2) identify the intangibles involved in producing and marketing the products made by the possessions corporation; (3) identify the method of pricing components purchased by the possessions corporation; and (4) submit on their tax returns a combined net income

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[8] Under the cost sharing option, the bill would increase the cost sharing payment for this product and, accordingly, the amount of income allocable to other members of the group, by at least $1 (10 percent of $10).

statement for the products manufactured by the possessions corporation.

Fifth, the bill modifies the definition of qualified possession source investment income ("QPSII") in order to allow the Government of Puerto Rico to fully implement its initiative to increase investment and employment in qualified CBI countries. Under present law, QPSII is limited to income derived from investments within a possession in which the taxpayer conducts an active trade or business. Further, the taxpayer must establish that QPSII is derived from the investment of funds which (1) are allocable to net income from the conduct of an active trade or business within the possession, or (2) constitute a reinvestment of QPSII. The government of Puerto Rico has established rules (Reg. 3087) which apply to financial institutions that accept deposits from possessions corporations. The purpose of these rules is to require that such deposits be invested only in specified assets located in Puerto Rico including: loans for commercial, agricultural, and industrial purposes; business and residential mortgage loans; loans and investments in securities of the Government of Puerto Rico and its instrumentalities; student loans; and automobile loans. In addition, financial institutions are required to invest 30 percent of possessions corporation deposits in Puerto Rico government obligations, including 10 percent in obligations of the Government Development Bank of Puerto Rico ("GDB").

Under the bill, subject to certification requirements, the GDB would be permitted to invest funds attributable to possessions corporations in loans for the acquisition or construction of active business assets located in qualified Caribbean Basin Initiative ("CBI") countries. A qualified CBI country is a "beneficiary country" (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the requirements of clauses (i) and (ii) of Code section 274(h)(6)(A). To qualify for a loan, the obligor must certify to the Secretary of the Treasury and the Government of Puerto Rico that the funds will be invested promptly in active business assets located in a qualified CBI country. The committee anticipates that the GDB would terminate a loan if the GDB or the Treasury Department determines that the borrower has not made a good faith effort to comply with the conditions of certification. Also, it is anticipated that the Government of Puerto Rico will make such conforming changes as are necessary in regulations pertaining to the use of GDB funds to permit loans for active business assets in qualified CBI countries, and to permit a local tax exemption for the income attributable to such loans. The Treasury Department will arrange with the Government of Puerto Rico procedures for examining the books of the GDB in order to ensure compliance with the active business asset requirement and to permit tax exemption for the income attributable to such loans.

The committee recognizes that the possession tax credit, as it currently operates, often results in an excessively high revenue loss for the amount of activity it generates in the possessions. Many of the problems in the operation of the credit are described above. In deciding to make relatively minor modifications to the credit, the committee has been motivated in large part by representations made by the Government of Puerto Rico that it intends to pursue

vigorously the twin plant initiative outlined in the "Memorandum of Agreement." [9]

The committee intends to exercise its oversight jurisdiction to review the operation of the possession tax credit periodically to ensure that the goals of economic development in both the possessions and the Caribbean Basin are being achieved. The committee anticipates that the Government of Puerto Rico will promote employment-producing investment in, as well as the transfer of technology to, qualified CBI countries. The committee believes that economic growth in the relatively poorer CBI countries will benefit both Puerto Rico and the United States by expanding trade opportunities and promoting political stability.

The committee believes that Puerto Rico, the most affluent of the Caribbean islands, is a model for economic development in the region, and has a special responsibility to assist in the economic development programs of other CBI countries. The Memorandum of Agreement provides, *inter alia*, that the Government of Puerto Rico will guarantee $100 million annually of new funds for private direct investment in qualified CBI countries. These funds are anticipated to be derived, without additional cost to the United States, from a variety of sources including: possessions corporations (in exchange for future Puerto Rican tax concessions); GDB funds; and grants by the Government of Puerto Rico.

The bill also amends section 936(d)(1) to include the U.S. Virgin Islands within the definition of "possession". This change has the effect of bringing U.S. corporations doing business in the Virgin Islands within section 936, rather than the separate but comparable provisions of the revised organic Act of the Virgin Islands and section 934.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985. Under a transition rule, the active income percentage increases from 65 to 70 percent for taxable years beginning in 1986, and to 75 percent for taxable years beginning after 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $41 million in 1986, $70 million in 1987, $69 million in 1988, $76 million in 1989, and $83 million in 1990.

2. Transfers of Intangibles to Related Parties Outside the United States (sec. 641 of the bill and secs. 367, 482, and 936 of the Code)

Present Law and Background

In general

A U.S. taxpayer may transfer intangible property or rights to use such property to a related corporation that is not subject to current U.S. tax because it is a foreign corporation or an electing

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[9] "Memorandum of agreement between the government of the United States and the Government of Puerto Rico (draft)," November 14, 1985.

section 936 corporation. Various provisions of present law attempt to limit the ability thus to obtain deferral or effective exemption of income attributable to the intangible by shifting the income from a U.S. taxpayer to a related entity not subject to U.S. tax.

Section 482

A related party license or sale of rights to use property is generally subject to the provisions of section 482 of the Code. That section authorizes the Treasury Department to allocate income among related parties as necessary to prevent the evasion of taxes or clearly to reflect the income of such parties.

Treasury Regulations under section 482 interpret this provision by attempting to determine what an arm's length charge between unrelated parties would have been. Following this approach, the regulations provide that appropriate allocations of income to reflect an "arm's length" consideration may be made if intangible property is transferred on other than arm's length terms. To determine an arm's length consideration, the regulations look to comparable transactions where they exist, and particularly to transfers by the same transferor to unrelated parties involving the same or similar property under the same or similar circumstances.

Where a sufficiently similar transaction with unrelated parties cannot be found, prevailing rates in the industry and bids of other parties, as well as prospective profits to the transferee, are among the factors that may be considered under the regulations. None of the factors is accorded special emphasis.

Depending on the circumstances, an arm's length consideration may take the form of a stated royalty or lump sum payment. Other methods of allocation could also be appropriate, depending on the circumstances.

Section 367

Where the U.S. taxpayer does not transfer the right to use the intangible to its foreign affiliate in the form of a license or sale, but rather as a transfer of the ownership of the intangible through a contribution to capital, the transfer is subject to section 367. Under that section, transfers of appreciated property, including intangibles, to related foreign corporations by a contribution to capital or similar transaction that would be tax free if made to a U.S. corporation were prior to 1984 generally treated as taxable sales where the transfer had as one of its principal purposes the avoidance of U.S. tax.

The Internal Revenue Service took the position that transfers to foreign corporations of patents, trademarks and similar intangibles for use in connection with a U.S. trade or business, or for use in connection with manufacturing for sale or consumption in the United States, generally had tax avoidance as a principal purpose and would be subject to a toll charge under section 367. Rev. Proc. 68-23, 1968-1 C.B. 821. By negative implication, no gain recognition was required with respect to transfers for use purely in connection with a foreign trade or business or manufacturing might have been viewed as nontaxable.

In response to the substantial tax advantages available to taxpayers if they could transfer intangibles to related foreign corpora-

tions without charge as a contribution to capital without the payment of any royalty or any allocation of income, Congress amended section 367(d) in 1984 to state that except as provided in regulations, a transfer of intangibles to a foreign corporation as a contribution to capital under section 351 or in a reorganization under section 361 would be treated as a sale of the intangibles. Intangibles for this purpose include any (i) patent, invention, formula, process, design, pattern, or know-how, (ii) copyright, literary, musical, or artistic composition, (iii) trademark, trade name, or brand name, (iv) franchise, license, or contract, (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (vi) any similar item, which property has substantial value independent of the services of any individual.

Section 367(d) provides that the amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. In general, the amounts are treated as received over the useful life of the intangible property on an annual basis. Thus, a single lump-sum payment, or an annual payment not contingent on productivity, use or disposition, cannot be used as the measure of the appropriate transfer price. Any amounts included in gross income by reason of this special rule are also treated as ordinary income from sources within the United States and thus cannot be sheltered by foreign tax credits.

Section 367 does not apply to possessions corporations under section 936 because such corporations are U.S. rather than foreign corporations.

Section 936

Because possessions corporations qualifying for the section 936 tax credit are U.S. rather than foreign corporations, section 367 does not apply to transfers of intangibles to possessions corporation by the their U.S. affiliates. Prior to statutory changes made in the 1982 Act, the appropriate treatment of transfers of intangibles to possessions corporations in the form of contributions to capital was not clear.

Some taxpayers took the position that such transfers of intangibles could be accomplished without the payment of any consideration or any allocation of income to the U.S. transfer. The Internal Revenue Service challenged this treatment in a number of cases involving transfers of intangibles to possessions corporations that performed manufacturing functions using the intangibles and sold the products back to U.S. affiliates. The Service aruges that these transactions in reality constituted contract manufacturing arrangements. Thus, it contends that the income attributable to the transferred intangible should be allocated entirely to the parent under section 482, with the possessions corporation retaining only a return on its manufacturing operations. In the one case decided on this question to date, *Eli Lilly and Company and Subsidiaries*, 84 T.C. No. 65 (1985), the tax court took an intermediate position. While it noted the absence of any royalty or other payment for the intangible, it did not conclude that under the particular facts such

a payment would be mandatory. However, on examination of the entire transaction, the court concluded that the prices charged on sales of goods back to the U.S. parent were too low and that a substantial portion of the profit from the goods manufactured and sold by the possessions corporation should be allocated to the U.S. parent.

Because of the substantial uncertainty in the area and because it considered the tax advantages claimed by certain taxpayers to be excessive, Congress amended section 936 in 1982 to provide specific rules for the allocation of intangibles income between a possessions corporation and a related entity that transfers intangibles to, or allows their use by, the possessions corporation. Generally, all income attributable to the intangible is taxed directly to the U.S. shareholders unless one of two specified options is elected. One option is a 50/50 profit split under which 50 percent of the profit is allocated to the U.S. parent. The other option is a cost-sharing option, under which the possessions corporation can claim a return on manufacturing (but generally not marketing) intangibles related to the products it produces if it makes a "cost-sharing" payment to its affiliates computed under a specified formula.[10]

If the cost-sharing option is elected, the possessions corporation is treated as the owner of the intangible. However, the principles of section 482 apply in determining the proper selling price of products it produces and sells to its mainland or other affiliate. The principles of section 482 also apply in distinguishing amounts that are attributable to marketing intangibles (such as trademarks, trade names, or corporate knowledge of and contacts with the marketplace) from amounts that are attributable to manufacturing intangibles (such as patents or know-how).

Reasons for Change

There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

The committee is concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.

Section 482

Many observers have questioned the effectiveness of the "arm's length" approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions be-

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[10] These provisions are discussed in greater detail in connection with the amendments dealing with section 936 possessions corporations.

tween unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables.[11]

A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries.[12] In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item.

The problems are particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

Certain judicial interpretations of section 482 suggest that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. *See, e.g., United States Steel Corporation v. Commissioner,* 617 F. 2d 942 (2d Cir. 1980). While the committee is concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believes that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles is necessary.

In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. The transferor may well be looking in part to the value of its direct or indirect equity interest in the related party transferee as part of the value to be received for the transfer, rather than to "arm's length" factors. Industry norms for transfers to unrelated

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[11] See, e.g., General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (GGD-81-81, September 30, 1981); Schindler and Henderson, Intercorporate Transfer Pricing 1985 Survey of Section 482 Audits (1985) and materials cited therein. Cf. Department of the Treasury, Internal Revenue Service, *IRS Examination Data Reveal in Effective Administration of Section 482 Regulations,* Report prepared by The Assistant Commissioner (Examinations). April, 1984.

[12] Schindler and Henderson, *supra* n.11. at p. 6. See GAO report, *supra* n.11.

parties of less profitable intangibles frequently are not realistic comparables in these cases.

Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. The committee believes, therefore, that this is the measure that should be used under section 367 and section 482 in the case of transfers to a foreign corporation.

With respect to possessions corporations electing the cost-sharing option under section 936, the committee is concerned that the cost-sharing payment computed under present law may not always allocate sufficient income to mainland affiliates with respect to manufacturing intangibles the possessions corporations are treated as owning under that option. The option looks to a sharing of costs that may be insufficiently related to the highly profitable intangible actually transferred. The committee believes that an appropriate floor for the cost-sharing payment is the royalty the possessions corporation would pay under section 482 or 367 principles, were they applicable with respect to such manufacturing intangibles.

Explanation of Provisions

The basic requirement of the bill is that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation must be commensurate with the income attributable to the intangible. This approach applies both to outright transfers of the ownership of the intangibles (whether by sale, contribution to capital, or otherwise), and to licenses or other arrangements for the use of intangibles.

In making this change, the committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. In determining whether the taxpayer could reasonably expect that projected profits would be greater than the industry norm, the committee intends that there should be taken into account any established pattern of transferring relatively high profit intangibles to Puerto Rico or low tax foreign locations.

The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer. Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the in-

tangible. The bill is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible.

In requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.

The requirements of the bill apply when intangibles of the type presently subject to section 367(d) are transferred by a U.S. person to a related foreign entity or to a possessions corporation that elects the cost-sharing option, or are licensed or otherwise used by such entity. Thus, the standard that payments must be commensurate with the income attributable to the intangible applies in determining the amounts to be imputed under section 367(d) and in determining the appropriate section 482 allocation in other situations. The standard also applies in determining the minimum amount of the "cost-sharing payment" to be made under the cost-sharing option in the case of an electing section 936 corporation. As discussed in greater detail in connection with the changes made by the bill affecting possessions corporations, the bill requires that the cost-sharing payment must be at least as great as the royalty the possessions corporation would have to pay to an affiliate under section 367 or 482 with respect to manufacturing intangibles the possessions corporation is treated as owning by virtue of electing the cost-sharing option.

Effective Date

For transfers (including licenses or other grants of use) from U.S. persons to foreign related parties, the provisions of the bill apply to transfers after November 16, 1985, in taxable years ending after that date. Where the parties have provided in an existing license or other arrangement for the transfer of newly developed or acquired intangibles, transfers of such new intangibles after November 16, 1985, in taxable years ending after that date, would be subject to the provisions of the bill.

No inference is intended as to whether the same result could nevertheless be reached under present law for transfers prior to these effective dates.

The change to the computation of the cost-sharing payment under section 936 for possessions corporations that elect the cost-

sharing option shall apply to taxable years beginning after December 31, 1985, with respect to all manufacturing intangibles any such possessions corporation is treated as owning by virtue of electing the cost-sharing option.

Revenue Effect

This provision, apart from its application to possessions corporations, is estimated to increase fiscal year budget receipts by $16 million in 1986, $42 million in 1987, $62 million in 1988, $85 million in 1989, and $109 million in 1990.[13]

3. Taxation of U.S. Government employees in Panama (Sec. 642 of the bill and sec. 912 of the Code)

Present Law

The Panama Canal Commission is a U.S. government agency that carries out the responsibilities of the United States under the Panama Canal Treaty with respect to the management, operation, and maintenance of the Panama Canal. An agreement between the United States and Panama entered into in conjunction with the Panama Canal Treaty (Agreement in Implementation of Article III) specifies the rights and legal status of the Commission and its employees. One article of the agreement provides an exemption from tax for U.S. employees of the Commission. In a diplomatic note, Panama has confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. A similar agreement between the United States and Panama governs the status of U.S. military installations and employees in Panama.

U.S. government employees stationed abroad are generally permitted to exclude from gross income certain housing, cost-of-living, and other allowances under Code section 912. The exclusions under section 912 apply only to allowances granted under certain specifically-enumerated statutory provisions. The statutes providing allowances and other benefits to U.S. employees of the Panama Canal Commission are not enumerated in section 912.

Reasons for Change

The Agreement in Implementation of Article III of the Panama Canal Treaty has been the subject of a substantial amount of litigation. Taxpayers have taken the position that the Agreement exempts the salaries of U.S. employees of the Panama Canal Commission from both U.S. and Panamanian taxation. Although most courts have upheld the U.S. Government's interpretation of the treaty, *see, e.g., Coplin v. U.S.*, 761 F.2d 688 (Fed. Cir. 1985), one appeals court excluded from consideration the U.S. explanation and Panamanian diplomatic note, and held that the plain language of the treaty requires a complete exemption from all taxes. *Harris v. U.S.*, No. 84-8424 (11th Cir. 1985). Similar controversy may exist with respect to the Agreement in Implementation of Article IV.

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[13] The impact with respect to possessions corporations is stated in the discussion of the possessions tax credit.

Although the *Harris* court's reading of the agreement may have been supported by the limited evidence before the court, the committee believes that such a reading of the agreement is patently inconsistent with the intent of the drafters and with the views of Congress as reflected in well-established U.S. treaty policy. The United States' technical explanation of the agreement, the Report of the Senate Foreign Relations Committee, and the diplomatic note provided by Panama, clearly establish that the treaty was not intended to provide a complete exemption from all taxes for Commission employees. Furthermore, the provision of any such benefit under the treaty would have been completely inconsistent with the treaty policy of the United States not to alter by treaty the U.S. tax treatment of U.S. persons, particularly with respect to income from services performed for the U.S. Government or its agencies. The committee finds nothing in the legislative history to indicate that Congress intended to contravene its well-established policies in this regard, in entering into the Panama Canal Treaty and its implementing agreements. In fact, the legislative history indicates that no such contravention was intended.

While the committee does not believe that employees of the Panama Canal Commission should be granted preferential tax treatment, neither does it believe that they should be treated worse than other overseas employees of the United States. Thus, such employees should be permitted to exclude from gross income allowances comparable to the allowances paid to other U.S. Government employees overseas.

Explanation of Provision

The bill clarifies that nothing in the Panama Canal Treaty (or in any agreement implementing the treaty) is to be construed as exempting any citizen or resident of the United States from U.S. tax.

The bill also provides that employees of the Commission stationed in Panama may exclude from gross income allowances which are comparable to the allowances excludable under Code section 912(1) by employees of the State Department stationed in Panama. The committee intends by this exclusion to equalize the treatment of U.S. government employees stationed in Panama, and thus does not intend to permit the exclusion of amounts greater than those that could be excluded by State Department employees, nor to permit the exclusion of allowances of any type unavailable to State Department employees.

Effective Date

The bill's clarification of the effect of the Panama Canal Treaty and its implementing agreements applies to all taxable years.

The amendment to section 912 is effective for taxable years beginning after 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $10 million per year.

4. Foreign Sales Corporation and Domestic International Sales Corporation Benefits (sec. 643 of the bill and secs. 291, 923, and 995 of the Code)

Present Law

Foreign Sales Corporations (FSCs) are typically foreign incorporated subsidiaries of U.S. parent corporations engaged in exporting. To qualify as a FSC, a corporation has to be organized under the laws of a jurisdiction outside the U.S. customs area and generally must meet certain foreign presence requirements. In addition, a FSC must meet foreign management and economic processes tests which do not apply in the case of the export income of a small FSC attributable to up to $5,000,000 of export receipts.

Under optional administrative pricing rules, a FSC may earn the greater of 23 percent of the combined taxable income that it and a related party derive from an export transaction, or 1.83 percent of the gross receipts from the transaction. The Code exempts a portion of the export income of a FSC from U.S. tax. If a transaction is subject to one of the administrative transfer pricing rules, the exempt portion is 16/23 of the FSC's income from the transaction, generally 16 percent of combined taxable income or 1.27 percent of the gross receipts from the transaction. Alternatively, under the section 482 pricing rules, the exempt portion is limited to 32 percent of FSC income. The Code reduces the exemption by an additional 1/17 for corporate shareholders. The rest of export income is subject to U.S. tax.

Companies may use another set of rules, the Domestic International Sales Corporation (DISC) rules, to defer tax on up to $10 million of export receipts but are required to pay interest based on the T-bill rate on the deferred tax. The Code reduces the deferral by 1/17 for corporate shareholders.

Reasons for Change

In connection with the lowering of tax rates for U.S. taxpayers generally, the committee has repealed or reduced a number of tax preferences. The committee believed it appropriate to reduce these export preferences in the context of its efforts to broaden the tax base and lower rates.

Explanation of Provision

The bill generally reduces the FSC and DISC preferences by approximately 2/17. The bill reduces the exempt portion of a FSC's income in a transaction using administrative pricing rules from 16/23 to 14/23. The bill reduces the exempt portion in a section 482 FSC transaction from 32 percent to 28 percent. In the case of a DISC, there is a 2/17 cutback in the deferred amount of earnings eligible for tax deferral. In each case, the 1/17 cutback applicable to corporate shareholders continues.

Effective Date

These provisions will apply in taxable years beginning on or after January 1, 1986.

Revenue Effect

These provisions are expected to increase fiscal year budget receipts by $70 million in 1986, $120 million in 1987, $115 million in 1988, $121 million in 1989, and $127 million in 1990.

5. Foreign Earned Income Exclusion (sec. 644 of the bill and sec. 911 of the Code)

Present Law

A U.S. citizen or resident is generally taxed on his or her worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under Code section 911, an individual who has his or her tax home in a foreign country and who is either present overseas for 330 days out of 12 consecutive months or who is a bona fide resident of a foreign country for an entire taxable year can elect to exclude an amount of his or her foreign earned income from his gross income. The maximum exclusion is $80,000 in 1985, increasing to $85,000 in 1988, $90,000 in 1989, and to $95,000 in 1990 and thereafter.[14]

An individual meeting the eligibility requirements may also elect to exclude (or deduct, in certain cases) his or her housing costs above a floor amount. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The provision contains a denial of double benefits by reducing such items as the foreign tax credit by the amount attributable to excluded income.

Reasons for Change

In connection with the lowering of tax rates for U.S. individuals, the committee has repealed or restricted a great number of tax preferences. In this context, the committee believes that it is appropriate to reduce the maximum potential preference for American earning active income abroad.

Explanation of Provisions

The bill limits the foreign earned income exclusion to $75,000 per year per U.S. individual. As under present law, the exclusion is computed at the annual rate on a daily basis.

Effective Date

This change is effective for all taxable years beginning on or after January 1, 1986.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $22 million in 1986, $38 million in 1987, $42 million in 1988, $49 million in 1989, and $52 million in 1990.

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[14] This scheduled increase in the exclusion was set in the Deficit Reduction Act of 1984. Under the Economic Recovery Tax Act of 1981, the exclusion was scheduled to increase to $85,000 in 1984, $90,000 in 1985, and to $95,000 in 1986 and thereafter.

E. Treatment of Foreign Taxpayers

1. Branch-Level Tax (sec. 651 of the bill and secs. 861, 883, 884, and new sec. 885 of the Code)

Present Law

In general, the United States seeks to tax foreign corporations that operate in the United States like U.S. corporations that operate in the United States. This goal of symmetrical treatment extends to dividend and interest payments. That is, the United States generally seeks to tax dividends and interest paid by foreign corporations most of whose operations are in the United States like dividends and interest paid by U.S. corporations that operate in the United States. If the recipient of the dividends or interest is a U.S. person, the United States imposes tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest is a foreign person, however, symmetry is more difficult to enforce.

A U.S. corporation that pays dividends to a foreign person not engaged in a trade or business in the United States generally must, in the absence of a contrary treaty provision, withhold 30 percent of the payment as a tax. The United States imposes the tax at a flat 30-percent rate because it is generally not feasible to determine and collect a net-basis graduated tax from foreign persons who may have very limited tax contacts with the United States. Similarly, a 30-percent withholding tax applies to some interest paid to foreign persons, including interest paid to related parties and certain interest paid to banks. In addition, U.S. income tax treaties reduce or eliminate the tax on interest paid to residents of the treaty country and reduce the tax on dividends paid to treaty residents to as little as 5 percent.

Similarly, a foreign corporation most of whose operations are in the United States that pays dividends or interest (of the types taxable if paid by a U.S. corporation) to a foreign person must withhold a portion of the payments (this is sometimes referred to as a second-level withholding tax). A foreign corporation becomes liable to withhold only when more than half of its gross income for a 3-year period is effectively connected with a U.S. trade or business. If the 50-percent threshold is crossed, the 30-percent (or lower treaty rate) tax applies to the allocable portion of the payment attributable to income of the paying foreign corporation that is effectively connected with its U.S. trade or business. One function of this withholding tax is to treat payments by foreign corporations with U.S. operations like payments by U.S. corporations.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits. In addition, its foreign shareholders are subject to a tax on the dividends which they receive (30 percent by statute, but frequently reduced to a lesser amount by treaty). Similarly, in certain circumstances interest payments made by a U.S. corporation to foreign creditors are subject to withholding (30 percent by statute, in the case of interest paid to related parties and in the case of certain bank interest, but frequently reduced or eliminated by treaty). No comparable shareholder-level tax is imposed by the United States on the distributed profits or remitted interest of a U.S. branch of a foreign corporation.

Where a foreign corporation chooses to conduct its U.S. operations through a U.S. branch, the second-level withholding tax of current law sometimes operates in the same way as the dividend and interest withholding taxes that would have applied had the U.S. operations been conducted through a separately incorporated U.S. subsidiary. However, the second-level withholding tax now applies only when a majority of the income of the foreign corporation is derived from its U.S. branch. Thus, a foreign corporation that derives a substantial amount of U.S. income but also operates extensively in other countries may not be liable for the second-level withholding tax. Interest and dividend payments made by U.S. corporations, on the other hand, are generally always subject to two levels of tax. Moreover, according to the Treasury Department, the second-level withholding tax is sometimes difficult to enforce. The committee is informed that it is often difficult to know when the tax is due, and if it is due, it is difficult to enforce its collection by a foreign corporation.

The committee is also concerned that present law—by subjecting U.S. corporations operating in the United States to corporate and shareholder levels of tax but subjecting many foreign corporations operating in the United States to corporate tax only—provides an unintended advantage to foreign corporations vis-a-vis their U.S. competitors.

The committee believes that the disparity between the taxation of U.S. corporations owned by foreign persons and the taxation of U.S. branches of foreign corporations should be reduced. The committee notes that there are corporate and shareholder levels of tax for U.S. corporations owned by U.S. persons and for U.S. corporations owned by foreign persons. The committee understands that nearly all foreign corporations with branches in the United States avoid liability for the second-level withholding tax (if not otherwise avoided pursuant to a tax treaty) by keeping their U.S. income beneath the 50-percent threshold. Thus, under current law, there is an undesirable incentive in many situations for foreign corporations to operate in the United States in branch form.

To reduce the disparity in U.S. tax treatment of U.S. subsidiaries and U.S. branches of foreign corporations and the disparity in U.S. tax treatment of U.S. corporations and foreign corporations that operate in the United States, the committee believes that a new branch-level tax should be enacted. In the committee's view, a branch-level tax is an appropriate substitute for a shareholder-level

tax: it should generally be easier to collect than the present second-level withholding taxes and it will not depend for its application, as those taxes do, on the foreign corporation's U.S. income exceeding an arbitrary threshold.

The committee recognizes the value of income tax treaties for U.S. persons engaging in international commerce. The committee believes, however, that a branch-level tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders. Therefore, the committee believes that permitting the branch tax to override conflicting treaties is not improper, since any discrimination involved is more technical than substantive. The committee is particularly concerned that if treaties were not overridden, foreign investors might attempt to use other countries' tax treaties to avoid the branch tax (i.e., they would treaty shop). However, where third-country investors are not using a treaty to avoid the branch tax, the committee is willing to allow the provisions of a treaty that prohibit imposition of a branch tax to take precedence over the tax, even though as later-enacted legislation the tax would normally override the treaty.

The committee also recognizes that the capitalization of a corporation, whether by stock or debt, is often motivated by tax concerns. Therefore, the committee believes that a dividend withholding rate should be applicable for payments to both stock and debt holders.

Explanation of Provision

In general

The bill generally eliminates the second-level withholding taxes of current law and replaces them with a branch-level tax on effectively connected income of foreign corporations. Under the bill, the tax is imposed on effectively connected income that is considered to be remitted to the head office of the foreign corporation and on certain interest payments attributable to the conduct of a trade or business in the United States. The tax rate is in both instances 30 percent.

Tax base—profits

The bill provides that the base for the tax on effectively connected income, the "dividend equivalent amount," is the foreign corporation's taxable income effectively connected with the conduct of a trade or business in the United States for the corporation's taxable year, subject to certain adjustments. The dividend equivalent amount is reduced by the U.S. income tax paid on the branch's effectively connected income. The tax base is further reduced to the extent the after-tax earnings are reinvested in the United States—determined as the increase in the adjusted basis of the branch's assets less its liabilities at the end of the year over the adjusted basis of its assets less its liabilities at the beginning of the year. Conversely, the tax base is increased in any subsequent year to the extent those reinvested earnings are repatriated from the United States—determined as the amount by which the adjusted basis of the branch's assets less its liabilities at the beginning of the year

exceeds the adjusted basis of the branch's assets less its liabilities at the end of the year. It is intended in the latter situation that the increase in the tax base be limited to the amount of the after-tax earnings of the branch that have been reinvested in the branch.

The bill provides that in measuring the adjusted basis of its assets and liabilities, the branch is to include only its assets and liabilities that are treated as connected with the conduct of the branch's U.S. trade or business. The bill provides that the includible assets and liabilities are only those assets and liabilities that are directly related to the income of the branch that is effectively connected with the conduct of its U.S. trade or business. However, if the foreign corporation is a resident of a country that has an income tax treaty with the United States and whose income tax treaty with the United States reduces the withholding tax rate on dividends, then the committee intends that that reduced rate apply to both the remitted profits and interest payments, unless the corporation is subject to the bill's treaty-shopping rule, described below in connection with the effective date. In the latter case, the 30-percent rate is to apply.

Tax base—interest payments

To eliminate the ability of a foreign corporation to capitalize its branch with debt and distribute its earnings as interest payments, the bill imposes a branch-level tax on the interest expense attributable to the conduct of a trade or business in the United States. The tax base for the branch-level tax on interest is the amount of interest attributable to the branch's trade or business in the United States that would be subject to withholding under sections 1441 or 1442 if the foreign corporation were a domestic corporation (other than an 80-20 company).

Regulations

The bill authorizes the Treasury Department to prescribe regulations necessary to carry out the purposes of the provision. For example, the regulations are intended to address the potential abuse that may arise in the event a branch temporarily increases its assets at the end of its taxable year merely to reduce its branch-level tax base. The regulations are also intended to address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year.

Tax credit

The bill further provides that if the branch-level tax is imposed on the dividend equivalent amount, there is to be a credit allowed to 10-percent U.S. corporate shareholders of the foreign corporation for their allocable share of branch-level tax (attributable to the dividend equivalent amount) that is paid when the foreign corporation distributes the earnings which include the branch income. For example, assume the branch of a foreign corporation earns $100 of income effectively connected with the conduct of a U.S. trade or business and that it does not reinvest any of its after-tax earnings in the United States. The United States imposes $36 of regular tax and $19 of branch tax ((100-36) x .30). Assume that the foreign corporation is, in turn, wholly owned by a U.S. parent corporation.

The bill provides that the U.S. parent corporation is allowed a credit of $19 against its tax liability when it receives the dividend from the foreign subsidiary corporation.

As is the case under present law (secs. 902 and 960), the bill provides that the dividend received by the U.S. corporate shareholder must be grossed up by the proportionate amount of the branch-level tax. In the example above, the amount of the gross-up is $19.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Relationship with tax treaties

In the event a particular treaty with a foreign country does not allow the bill's branch-level tax but does allow either of the Code's second-level withholding taxes of present law (either the second-level withholding tax on interest or the second-level withholding tax on dividends), the bill provides that, to that extent, the present law second-level withholding taxes are to continue to apply. Otherwise, the bill repeals the second-level withholding taxes of current law.

In general, it is not intended for the bill's branch-level tax to apply in situations where its application would be inconsistent with an existing U.S. income tax treaty obligation. However, the bill provides that the branch-level taxes are to apply to treaty-shopping situations, notwithstanding any conflicting treaty provisions, if the treaty prevents both the branch-level tax and present law's second-level withholding taxes. The bill provides that a foreign corporation is treaty-shopping in the circumstances where more than 50 percent (by value) of the beneficial owners of the foreign corporation are not residents of the treaty country. However, if the foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, the bill provides that it is considered a resident of that country for this purpose.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $16 million in 1986, $27 million in 1987, $31 million in 1988, $34 million in 1989, and $37 million in 1990.

2. Retain character of effectively connected income (sec. 652 of the bill and sec. 864 of the Code)

Present Law

The United States taxes the world-wide income of U.S. citizens, residents, and corporations on a net basis at graduated rates. Nonresident aliens and foreign corporations are generally taxed only on their U.S. source income. The United States taxes foreign taxpayers' income that is "effectively connected" with a U.S. trade or business on a net basis at graduated rates, in much the same way that it taxes the income of U.S. persons. U.S. income of a foreign taxpayer that is not connected with a U.S. trade or business is gen-

erally subject to a 30 percent withholding tax on the gross amount of such income. Many U.S. tax treaties reduce the 30 percent withholding tax, and payments of portfolio interest are no longer subject to the withholding tax. The United States does not generally tax foreign taxpayers on capital gains that are not connected with a U.S. trade or business (real property gains are the major exception to this rule).

Reasons for Change

Under present law foreign taxpayers can avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist. For example, the business can sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer can defer the income to a later taxable year. If the taxpayer has no U.S. trade or business in that year, then the income recognized in that year is not treated as effectively connected with a U.S. trade or business. The committee believes that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similar considerations apply to income from the performance of services in the United States, where payment of the income is deferred until a subsequent year when the individual is not in the United States.

Explanation of Provision

The bill amends section 864(c) to provide that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated if it had been taken into account in that other taxable year. Thus, deferring the recognition of income until a later taxable year will no longer change the manner in which the U.S. tax system treats the income.

Effective Date

The provision applies to taxable years beginning after 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $10 million per year.

3. Application of accumulated earnings tax and personal holding company tax to foreign corporations (sec. 626 of the bill and secs. 535 and 545 of the Code)

Present Law

The accumulated earnings tax and personal holding company tax are imposed on corporations that accumulate earnings rather than distributing them to their shareholders. The taxes are imposed on accumulated taxable income and undistributed personal holding company income, respectively. Those amounts are calculated by

making several adjustments to the regular taxable income of a corporation, including deductions for net capital gains (and certain capital losses). A deduction for net capital gains is granted because the corporate and individual tax rates on capital gains are approximately equal, and there is therefore little incentive to accumulate capital gains in a corporation.

Foreign corporations are generally subject to these taxes if they have any shareholders that would be subject to U.S. tax on a distribution from the corporation. In the case of a foreign corporation, only U.S. source income enters into the calculation of the accumulated earnings tax or personal holding company tax. However, net capital gains may be deducted from taxable income (thus reducing the accumulated earnings tax or personal holding company tax), even if the capital gain is not otherwise taken into account for U.S. tax purposes because it is not effectively connected with a U.S. trade or business. Thus, capital gains that are not subject to U.S. tax may nevertheless reduce the accumulated earnings tax or personal holding company tax. United States source capital gain income realized by a foreign corporation trading in stock, securities, or commodities for its own account is not considered effectively connected income.

Reasons for Change

A foreign corporation may be able to use the net capital gain deduction to avoid application of the accumulated earnings tax or personal holding company tax, even when the corporation accumulates substantial gains that are subject to no U.S. tax. In such a case the basis for the capital gain deduction—equivalency of corporate and individual tax rates—is absent, since the corporate tax rate on the gains is zero. Foreign or U.S. individuals could use such a corporation to accumulate, and defer U.S. taxation of, gains from investments in stock, securities, or commodities. The committee does not believe that taxpayers should be permitted to use such a device to avoid application of the accumulated earnings tax or foreign personal holding company tax. Therefore, the committee has concluded that in the case of a foreign corporation a net capital gain deduction for accumulated earnings tax or personal holding company tax purposes should be allowed only with respect to gains that are effectively connected with the conduct of a U.S. trade or business.

Explanation of Provision

The bill amends sections 535 and 545 to provide that the accumulated earnings tax or personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account only if they are effectively connected with the conduct of a U.S. trade or business. Gains which are exempt from U.S. tax under a treaty obligation of the United States will not be considered effectively connected for this purpose.

Effective Date

The provision applies to gains and losses realized on or after November 16, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $10 million per year.

4. Tax-free exchanges by expatriates (sec. 653 of the bill and sec. 877 of the Code)

Present Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will, for ten years, continue to be taxed as a citizen on U.S. source income, but not foreign source income, under Code section 877. U.S. income of such tax-avoidance expatriates will thus be subject to tax on a net basis at graduated rates, regardless of how such income would be taxed to a nonresident alien. U.S. income for this purpose includes gains from sales of U.S. property (i.e., property located in the United States, stock of U.S. corporations, and debt obligations issued by any U.S. person, including Federal, state and local governments).

Reasons for Change

Tax-avoidance expatriates may under present law be able to avoid U.S. tax by making a tax-free exchange of U.S. property for foreign property. The sale of the U.S. property would be subject to U.S. tax, but the sale of the foreign property would not be. The committee believes that expatriates should not be permitted to accomplish indirectly that which they are prohibited from doing directly.

Explanation of Provision

The bill amends section 877 to provide that gain on the sale or exchange of property whose basis is determined in whole or in part by reference to the basis of U.S. property will be treated as gain from the sale of U.S. property. Thus, expatriates will still be permitted to make tax-free exchanges of U.S. property for foreign property. However, a subsequent disposition of that foreign property (on which gain is recognized) will be treated as a disposition of U.S. property, and will therefore be subject to U.S. tax.

Effective Date

The provision applies to dispositions of property acquired in tax-free exchanges after September 25, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

5. Excise Tax on Insurance Premiums Paid to Foreign Insurers and Reinsurers (sec. 654 of the bill and secs. 4371-74 of the Code)

Present Law

Under present law, an excise tax is imposed (Code sec. 4371) on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States. The excise tax is imposed at the rate of (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of a life, sickness, or accident insurance, or annuity contract on the life or hazards to the person of a U.S. citizen or resident, unless the insurer is subject to tax under Code section 813 (relating to the taxation of foreign life insurance companies); and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

Present law (Code sec. 4373) provides exemptions from the excise tax in the case of (1) policies signed or countersigned by an officer or agent of the insurer in a State or the District of Columbia, within which such insurer is authorized to do business, or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States.

Thus, present law imposes a tax on any direct insurance transaction with a foreign insurer (not subject to U.S. income tax), and an additional tax on any reinsurance transaction with a foreign insurer, if the transaction involves the insurance or reinsurance of a U.S. risk. A policy of reinsurance issued by a foreign insurer covering U.S. casualty risks or U.S. life risks is subject to the tax imposed on reinsurance policies, whether the direct insurer is a domestic or foreign insurer. Rev. Rul. 58-612, 1958-2 C.B. 850. See also *American Bankers Insurance Co. of Florida* v. *United States*, 388 F.2d 304 (5th Cir. 1968).

The excise tax also may be waived under certain recent U.S. tax treaties, such as it is in the United States-United Kingdom Income Tax Treaty or in the United States-France Income Tax Treaty. Although premiums received by certain persons may be exempt from the excise tax (whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person.

Code section 4374, as amended by the Tax Reform Act of 1976, provides that the excise tax imposed by Code section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues, or sells any of the documents and instruments subject to the

taxes, or for whose use or benefit the same are made, signed, issued, or sold. Thus, the liability for the tax falls jointly on all the parties to the insurance transaction.

Treasury regulations (Treas. Reg. sec. 46.4374-1) (which do not reflect the changes made by the Tax Reform Act of 1976) provide that the tax is to be remitted by the U.S. person who actually transfers the premium to the foreign insurer or reinsurer or to any nonresident agent, solicitor, or broker. There is no provision that requires the U.S. person to withhold any excise tax owed by a foreign insurer or reinsurer.

Reasons for Change

The committee believes that the present law excise tax system consisting of one tax on the direct insurance of a U.S. risk with a foreign insurer and another tax, which generally is in addition to the first, on the reinsurance of a U.S. risk with a foreign insurer, should be replaced with a more administrable system. The new system will ensure that an excise tax is collected in all events to the extent a U.S. risk is insured, whether directly or indirectly, by a foreign insurer that is not subject to U.S. income tax or otherwise exempt from the excise tax. The committee believes that the policy of imposing an excise tax on insurers and reinsurers that are not subject to the net income tax will be better served by this new system under which the foreign insurer (or its agent) will be liable for the excise tax and the U.S. insured or broker that is obligated to transmit the premiums will be required to withhold the tax.

The committee is also concerned that the present tax rate differentiation between direct insurance and reinsurance of U.S. casualty risks allows U.S. insureds to avoid the proper level of excise tax by careful structuring of insurance and reinsurance transactions. In light of the bill's restructuring of the application of the excise tax, as well as concern over cases of tax avoidance, the committee believes that the excise tax rate applicable to a reinsurance transaction should reflect the character or class of the contracts issued by the direct insurer.

The bill's provisions are very similar to a set of provisions included in the Senate version of the Tax Reform Act of 1984. The 1984 Senate provisions were deleted in conference to allow Congress additional time to study the issues raised by the present law insurance excise tax rules and, in the spirit of comity, to provide the United Kingdom, where many foreign insurers of U.S. risks operate, and whose income tax treaty with the United States does not provide an effective mechanism to collect U.S. tax on reinsurance of U.S. risks with nonexempt insurers, an opportunity to establish that internal U.S. law should remain as it is. The committee believes that the United Kingdom has thus far made incomplete efforts in this regard. The committee understands that the Treasury Department initiated a series of communications with the U.K. Government beginning in November 1984 to gather information on whether the ceding of U.S. risks by U.K. insurers and reinsurers to reinsurers located in third countries increased after the present U.S.-U.K. income tax treaty generally entered into force in 1980. A substantial increase would suggest that the treaty waiver of the in-

surance excise tax referred to above has resulted in third-country reinsurance of U.S. risks through U.K. entities (rather than directly) in an attempt to gain the benefit of the treaty tax waiver.

The committee is informed that the Treasury Department received from the U.K. Government in November 1985 a note on a study of the effect of the treaty exemption on the business practices of U.K. insurance companies. The study does not address the question of whether the ceding of U.S. risks by U.K. insurance companies increased after the present U.S.-U.K. treaty became effective. The study does indicate that most large direct insurance contracts covering U.S. risks that were entered into by U.K. insurance companies, recorded in 1984, and reinsured were reinsured on an excess of loss or proportional basis so that the identity of the U.S. risk was lost. While the committee does not view the study as conclusive, the data provided can be interpreted to suggest that third-country reinsurers generally do not affirmatively initiate large "back-to-back" facultative insurance transactions involving U.S. risks through U.K. conduit entities. However, given the significance of third-country reinsurance of U.S. risks insured or reinsured by U.K. insurers, the committee remains concerned that third-country reinsurers may under present law obtain a substantial part of the economic benefit of the treaty excise tax waiver and may reinsure more U.S. risks as a result.

Assertions were made in 1984 that negotiators for the United States and the United Kingdom, in connection with the negotiation of the income tax treaty, may have reached an unwritten understanding that the United States would not impose its insurance excise tax on premiums for the reinsurance of U.S. risks paid by U.K. insurers to reinsurers in other foreign countries. As the conferees noted in 1984, unwritten understandings do not bind Congress. Only open covenants normally warrant Congressional recognition. The committee does not agree with the suggestion that understandings unknown to Congress and not part of the public record during the ratification process become law in the United States.

The committee shares the view of the 1984 conferees that the excise tax reform provisions do not violate any U.S. income tax treaty. They only collect a tax that the United States has the power to impose and collect under any U.S. income tax treaty and, thus, are fully consistent with all U.S. treaty obligations.

Explanation of Provisions

Excise tax rate

Generally, the bill conforms the excise tax rate imposed on a policy of reinsurance covering any policy of casualty insurance or the indemnity bond for a U.S. risk, if the policy of reinsurance is insured by a foreign insurer or reinsurer, to that imposed on a policy of direct insurance covering the same class of risks. The excise tax imposed on the insurance or reinsurance of U.S. casualty risks will be 4 percent of the premium received by a foreign insurer on the policy of insurance or reinsurance; the excise tax on the insurance or reinsurance of U.S. life risks will be 1 percent of the

premiums received by a foreign insurer on the policy of insurance or reinsurance.

The bill eliminates the potential additive impact of the present law provision for excise taxes on direct insurance and reinsurance with foreign insurers. In general, it provides that, to the extent an excise tax has been paid with respect to the U.S. risk under a contract of direct insurance with a foreign insurer, no excise tax will be due upon any subsequent reinsurance of such U.S. risk. Also, the bill provides generally that the foreign insurer or reinsurer is liable for the excise tax on the policy of insurance and that the amount of tax will be determined on the basis of the premiums retained by the foreign insurer or reinsurer. For these purposes, premiums retained means gross premiums and other consideration received by the foreign insurer with respect to the risks covered by the policy, reduced by premiums paid by such insurer for reinsurance ceded with respect to such risks. If the premiums paid for insurance or reinsurance are paid to an insurer who is entitled to a treaty exemption, then, to the extent the insurer retains the risk, the committee does not intend imposition of the tax on those premiums.

For example, assume that a U.S. person insures its home office building with a U.K. insurer for a premium of $100x, that the U.K. insurer cedes a portion of the covered risk to a Bermuda reinsurer for a premium of $30x, and that the Bermuda reinsurer does not cede the risk further. To the extent the premiums for the U.S. risk are retained by the U.K. insurer ($70x), no excise tax is due because of a treaty exemption; to the extent premiums for the reinsurance of the U.S. risk are retained by the Bermuda reinsurer, an excise tax of $1.2x is due ($30x multiplied by .04). For comparison, assume that the U.S. person had insured directly with a Bermuda insurer (for a premium of $100x), which in turn ceded a portion of the U.S. risk to a U.K. reinsurer (for a premium of $30x). An excise tax of $2.8x is due for the Bermuda insurer and none is due on the reinsurance contract from the U.K. reinsurer. If, in this example, the facts are the same except that both the insurer and the reinsurer are French residents entitled to a treaty exemption, no U.S. tax is due.

Withholding for excise tax

The bill adopts a withholding provision to aid in the administration and collection of the excise tax with respect to subsequent reinsurance of U.S. risks in transactions between exempt foreign insurers and nonexempt foreign insurers or reinsurers. Generally, when a foreign insurer or reinsurer issues a policy or contract that would be subject to the excise tax, the person who controls, receives, has custody of, disposes of, or pays the premiums to the foreign insurer or reinsurer must withhold from those premiums an amount to cover any excise tax that will be imposed upon premiums paid and retained by the foreign insurer or a reinsurer in a subsequent reinsurance of the covered U.S. risks. Because the amount of the reinsurance premiums may be unknown to the person responsible for withholding the excise tax on the premiums, the amount of the withholding will be based on the amount of the premiums being paid to the foreign insurer or reinsurer with re-

spect to the directly covered U.S. risks. The Treasury Department will have general authority to provide, by regulations, for the proper refund of any overwithholding or for the exemption from this withholding requirement. For example, Treasury might waive the withholding requirement if an exempt foreign insurer agrees to act as the withholding agent for the U.S. excise tax due because of subsequent reinsurance transactions or otherwise agrees to arrangements that insure that the excise tax on reinsurance will be collected.

Effective Date

The provisions apply for premiums paid after December 31, 1985.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $23 million in 1986, $39 million in 1987, $44 million in 1988, $49 million in 1989, and $55 million in 1990.

6. Tax on Transportation Income (Sec. 613(b) and 613(c) of the bill and secs. 872 and 883 and new secs. 886 and 887 of the Code)

Present Law

Overview

In general, the United States taxes the worldwide income of U.S. persons whether the income is derived from sources within or without the United States. On the other hand, nonresident aliens and foreign corporations (even those which are subsidiaries of U.S. companies) generally are taxed by the United States only on their U.S. source income and income effectively connected with a U.S. trade or business.

The U.S. tax laws contain a number of special rules which result in international transportation income, of both U.S. and foreign persons, being subject to very little U.S. tax. Foreign countries often tax U.S. persons on income from foreign shipping operations.

Foreign flag transportation

In the case of foreign owned transportation entities, the principal special rule exempting them from U.S. tax on their U.S. income is the reciprocal exemption (Code secs. 872(b)(1) and (2) and 883(a)(1) and (2)). Under the reciprocal exemption provisions, foreign owners are exempt from U.S. tax on U.S. source transportation income as long as the income is derived from the operation of a ship or aircraft documented or registered under the laws of a foreign country which grants an equivalent exemption for the transportation income of (or imposes no tax on the income of) citizens and corporations of the United States. The determination that a foreign country grants an equivalent exemption is usually made by an exchange of notes between the two countries. Reciprocal exemptions under these provisions (or under treaties) are presently in effect with respect to most foreign countries. The reciprocal exemption provisions apply independently with respect to shipping and aircraft income. Thus, while in most cases both types of income are

covered by the exemptions, in some cases the exemptions extend to one but not the other.

In addition to the reciprocal exemption provided in the Code, the United States has approximately 40 income tax treaties providing for reciprocal exemption which would exempt transportation income from taxation by either country even if there were no statutory exemption. (Although there is substantial overlap, the scope of the typical treaty reciprocal exemption is somewhat different from the statutory reciprocal exemption.) These treaties are in effect with virtually all of the developed countries.

Even in those cases where a reciprocal exemption under the Code or a treaty is not in effect, relatively little U.S. tax is imposed on the international transportation income of foreign corporations since the present source rules for transportation income (sec. 863) treat only a relatively small portion of the total international transportation income as from U.S. sources. Under the present source rules, the portion of a foreign corporation's transportation income that is treated as U.S. source and thus subject to U.S. tax is generally limited to that proportion of its income that its costs incurred in the transportation business in the United States and a reasonable return on its assets used in the transportation business in the United States bear to the entire costs incurred in the transportation business and a reasonable return on all of the assets used in the transportation business. Under regulations, a vessel or aircraft generally is considered to be "within" the United States only when it is within U.S. territorial waters or air space (sec. 1.863-4(c)). Thus, most of the income earned by foreign flag transportation companies from operating in the international commerce of the United States is treated as earned in international air space or international waters "without" the United States and, consequently, not subject to U.S. tax.

U.S. controlled foreign flag transportation

Benefits from the Code reciprocal exemption and the treaty provisions are derived not only by strictly foreign operators, but also by U.S. citizens and domestic corporations operating ships and aircraft through foreign subsidiaries. Most international shipping businesses of U.S. citizens and corporations are conducted through foreign subsidiaries. A substantial percentage of U.S.-owned foreign ships are registered in one of three countries: Liberia, the United Kingdom, or Panama, each of which qualifies for the reciprocal exemptions.

Operators who incorporate abroad and who register their ships or aircraft in a foreign country with no intention of operating the ships or aircraft in the domestic or foreign commerce of that foreign country are often referred to as using flags of convenience. As a general rule, most "flag of convenience" shipping companies, including those registered in Liberia and Panama, are able to obtain the reciprocal exemption provided in the Internal Revenue Code. On the other hand, ships and aircraft registered in developed countries are generally used in the domestic and foreign commerce of the country of registry and thus are generally entitled to the reciprocal tax exemption provided in the applicable U.S. tax treaty as well as the reciprocal exemption provided by the Code.

Reasons for Change

The committee believes that expanding the source rules for transportation income (as provided in sec. 613(a) of the bill and Code sec. 863(c), which generally provides that 50 percent of all inbound or outbound transportation income is U.S. source) will cause foreign persons who cannot avail themselves of either the reciprocal exemption provisions or treaty exemption provisions to earn a greater amount of U.S. source income than under present law. The committee believes that a simpler system of taxing foreign persons engaged in transportation business should be developed. Recognizing the administrative burden imposed on foreign persons in calculating taxable income for U.S. purposes, the committee believes a gross-basis tax on U.S. source transportation income of foreign persons should be enacted in the event the foreign person is not engaged in a U.S. trade or business (and is not therefore subject to U.S. tax on a net basis). The committee recognizes that present law imposes a gross-basis tax on foreign persons when the net-basis tax is not easily administered.

Currently, the reciprocal exemption provisions eliminate U.S. tax on foreign persons (even U.S.-controlled foreign corporations) by allowing exemptions based on country of documentation or registry without regard to the residence of persons receiving the exemption or whether commerce is conducted in that country. This puts U.S. persons with transportation operations and subject to U.S. tax at a competitive disadvantage vis-a-vis their foreign counterparts who claim exemption from U.S. tax and are not taxed in their countries of residence or where the ships are registered. The reciprocal exemption provisions were not enacted to provide worldwide exemption from income tax. Instead, the committee believes that the reciprocal exemption provisions were enacted to not only promote international commerce but to reserve the right to impose tax on transportation income to the country of residence of the taxpayer and, therefore, to eliminate double taxation.

The committee believes that using a flag of convenience in which to register a ship or aircraft circumvents the purpose of the reciprocal exemption. However, the committee believes that the present rules do not properly allow for U.S. taxation when the United States should properly assert its tax jurisdiction.

Furthermore, the committee believes that a revised reciprocal exemption and increased U.S. taxation for ships flying flags of convenience will encourage developing countries that do not have a significant local flag fleet to enter into reciprocal exemptions with the United States to exempt U.S. persons from tax.

Explanation of Provision

Gross-basis tax

The bill provides for a gross-basis tax on the U.S. source transportation income of foreign persons. The bill uses the present law source rule definition of transportation income. Thus, transportation income is gross income derived from, or in connection with, the use (or hiring or leasing for use) of any vessel or aircraft, or the performance of services directly related to such use. Under the bill,

however, the applicable source rules are changed to provide that when such income is attributable to transportation which begins or ends in the United States, it will be treated as 50 percent U.S. source income and 50 percent foreign source income without regard to the percentage of the related costs incurred or assets located in the United States (sec. 613(a) of the bill and Code sec. 863(c)).

The tax rate provided in the bill is four percent of the gross amount. The committee intends, if Code sections 871 or 881 (relating to withholding tax on certain types of fixed or determinable payments) would apply under present law, that the four-percent tax apply instead. Thus, the four -percent tax is to apply to rental income derived from bareboat charter operations rather than the 30-percent tax.

The bill provides, however, that if the foreign person is engaged in a trade or business in the United States and the foreign person's transportation income is effectively connected with that trade or business, the foreign person must, in lieu of paying the four percent gross-basis tax, file a U.S. tax return and pay tax on the basis of its net income.

The bill provides, however, that in order for the foreign person's transportation income to be effectively connected with the conduct of a U.S. trade or business, the foreign person must have regularly scheduled aircraft or vessels that come into and out of the United States to which substantially all of its U.S. source transportation income is attributable and the foreign person must maintain an office in the United States through which the foreign person conducts its U.S. transportation business. Thus, foreign persons are not able to merely make an occasional flight or voyage to the U.S., treat themselves as being engaged in a U.S. trade or business, and avoid the gross-basis tax.

The bill provides that the tax is to be withheld by the person (U.S. or foreign) that controls the payment of income to the foreign person. Thus, if a foreign person makes a voyage to the U.S., the person responsible to withhold is the person responsible for providing the foreign person's remuneration. That person is to deduct from the gross amount of the payment (or payments) four percent. The bill authorizes the Internal Revenue Service to require a bond by the foreign person in order to insure payment of the tax. The bill also authorizes Treasury regulations or other procedures to be issued by the Secretary to insure the proper administration of the provision.

The bill provides that the residence-based reciprocal exemption (as described below) applies to gross income (instead of earnings as under present law). Therefore, the residence-based reciprocal exemption provisions apply to the gross-basis tax.

This 4-percent tax provision is not intended to override U.S. income tax treaties with foreign countries. Therefore, if a foreign person is able to avail itself of a treaty exemption, it is not subject to the tax.

The committee intends that the amount of income subject to the U.S. gross-basis tax be the highest amount of U.S. source transportation income that is earned by foreign persons. For example, assume a foreign person resident of one foreign country, contracts with a second foreign person, a resident of a second foreign coun-

try, to deliver a shipment of goods to the United States. The second foreign person, in turn, contracts with a third foreign person resident in a third foreign country, to transport the goods to the United States. Assume further that the United States and the third foreign country have a treaty which exempts that country's residents from imposition of U.S. tax on U.S. source transportation income. Also, the United States and the second foreign country have an equivalent reciprocal exemption agreement. Assume further that a U.S. person remits $1000 to the third foreign person in payment for the goods. The third foreign person, in turn, remits $900 to the second foreign person for payment, and the second foreign person remits $800 to the first foreign person. The U.S. source transportation income subject to the four percent gross-basis tax in this example, in the absence of an exemption, is $500, 50 percent of the $1,000 payment. Under the bill, the U.S. payor does not have to withhold four percent of $500 because of the treaty with the third foreign country. Because of the reciprocal exemption agreement, there also is no withholding required on the $450 U.S. source portion of the payment from the third to the second foreign person. However, withholding is required with respect to the $400 U.S. source portion of the payment by the second foreign person to the first since that is the highest amount of U.S. source transportation income subject to U.S. tax. The Secretary is to promulgate regulations in the above circumstances in order to determine procedures which to collect U.S. tax.

The bill also provides, however, that no tax is imposed if a foreign person establishes that a prior tax was paid with respect to such person's U.S. source transportation income.

Reciprocal exemption

The bill modifies the present law provisions of the reciprocal exemption by looking at the foreign person's residence for purposes of claiming exemption from U.S. tax instead of looking at the place of registry or documentation (as under present law).

The bill provides that an alien individual must be a resident of a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption in order for the alien individual to avail himself of the reciprocal exemption. A foreign corporation must be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption in order for the corporation to avail itself of the reciprocal exemption.

However, the bill further provides that in the case of a foreign corporation claiming a reciprocal exemption if 25 percent or more of the ultimate owners of the foreign corporation (determined under the principles of secs. 958(a) and 958(b), relating to direct, indirect, and constructive ownership) are not residents of a foreign country that grants U.S. persons equivalent exemption, the foreign corporation is not able to claim the reciprocal exemption in order to avoid U.S. tax. The committee intends that for purposes of determining whether a country has an equivalent exemption, such exemption; either by statute or treaty, is to be based on residence.

The committee intends that residence for these purposes is intended to follow the definition of residence in an income tax treaty between the U.S. and the countries in which the owners of the for-

eign person or alien individual reside. If no treaty exists, residence is to be defined under U.S. tax principles.

For purposes of applying the 25-percent test to a foreign corporation (or other type of entity), if the foreign corporation is a U.S. controlled foreign corporation, the U.S. shareholders of the foreign corporation are treated as residents of the foreign country in which the corporation is organized. The bill also provides that the look-through rule does not apply to a foreign corporation if the stock of the corporation is primarily and regularly traded on an established securities market in the foreign country in which the corporation is organized. For this purpose, primary is intended to mean trading the securities more in the country of organization than in any other country.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $176 million in 1986, $92 million in 1987, $58 million in 1988, $62 million in 1989, and $66 million in 1990.

F. Taxation of Foreign Currency Exchange Rate Gains and Losses (sec. 661 of the bill and and Sec. 904 and new Secs. 985-989 of the Code)

Present Law

Background

When a U.S. taxpayer uses foreign currency as a medium of exchange, gain or loss (referred to as "exchange gain or loss") may arise from fluctuations in the value of the foreign currency in relation to the U.S. dollar. This result obtains because foreign currency is treated as personal property, and not as equivalent to the U.S. dollar, for Federal income tax purposes.

The principal issues presented by foreign currency transactions relate to the timing of recognition, the character (capital or ordinary), and the geographic source (domestic or foreign) of exchange gains or losses. Another area of concern is the treatment of U.S. taxpayers that operate abroad through a branch or a subsidiary corporation that keeps its books and records in a foreign currency; here, the issues relate to the method used to translate results recorded in a foreign currency into U.S. dollars.

Most of the rules for determining the Federal income tax consequences of foreign currency transactions are embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application are provided by Treasury regulations and, in a few instances, statutory provisions.

Foreign currency transactions

Foreign exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency is acquired for personal use.[15] Under the so-called "separate transactions principle," both the courts and the IRS require that exchange gain or loss be separately accounted for, apart from any gain or loss attributable to an underlying transaction.[16]

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[15] *See* Rev. Rul. 74-7, 1974-1, C.B. 198 (the IRS ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency).

[16] Although the law on this point is fairly well settled, there is a contrary line of older cases that provides authority for determining overall gain or loss by aggregating exchange gain or loss and gain or loss from the underlying transaction. Compare *National-Standard Co.* v. *Commissioner*, 80 T.C. 551 (1983), aff'd, 749 F.2d 369 (6th Cir. 1984) (where the taxpayer and the IRS stipulated that the separate transactions principle applied) with *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (where the U.S. Supreme Court determined that no net income was realized where the overall transaction generated a loss that exceeded an exchange gain on repayment of a foreign currency loan). There are two well recognized exceptions to the separate transactions principle: (1) a dealer in foreign exchange can use the lower of cost or value to determine for-

Continued

Debt denominated in a foreign currency

Treatment of debtors

In general.—A taxpayer may borrow foreign currency to use in a trade or business (e.g., to satisfy an account payable) or to make an investment in a foreign country. At maturity of a loan denominated in a foreign currency, typically, the taxpayer must obtain units of the foreign currency—in exchange for U.S. dollars—to repay the loan. If the foreign currency increases in value before the repayment date, the amount of U.S. dollars required to retire the debt would exceed the U.S.-dollar value of the foreign currency originally borrowed, and the taxpayer would suffer an economic loss. Conversely, if the foreign currency depreciates in value, the taxpayer would be able to discharge the debt at a reduced cost (because fewer U.S. dollars would be needed to obtain the number of units of foreign currency originally borrowed); here, the taxpayer would realize an economic gain.

Example (1).—Assume a U.S. taxpayer borrows 24 million Japanese yen when the rate of exchange is 240 yen per U.S. dollar. Thus, the U.S.-dollar value of the loan is $100,000.[17] At maturity of the loan, the borrower must repay 24 million yen, without regard to fluctuations in the yen: dollar exchange rate.

If the exchange rate on the date of repayment were 220 yen per dollar (*i.e.*, if the U.S.-dollar value of the yen increased to approximately $.004545), there would be a loss of $9,091 because $109,091 would be needed to purchase 24 million yen.[18]

If the exchange rate on the date of repayment were 260 yen per dollar (i.e., if the U.S.-dollar value of the yen fell to approximately $.003846), there would be a gain of $7,692 because only $92,308 would be required to obtain 24 million yen.

Character of exchange gain or loss on repayment.—Characterization as capital gain or loss depends on whether the discharge of a foreign-currency denominated obligation is viewed as the disposition of a "capital asset"[19] in a sale or exchange.

There is a substantial body of case law under which the use of property to discharge an obligation is treated as a sale or exchange of the property.[20] Under this line of cases, realized gain or loss is measured by the difference between the adjusted basis of the property transferred and the principal amount of the obligation. In

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eign currency inventory, (Rev. Rul. 75-104, 1975-1 C.B. 18), and (2) a foreign branch of a U.S. taxpayer may translate unremitted foreign-currency denominated profits into dollars at the exchange rate in effect at the end of a taxable year, as described below.

[17] At the exchange rate of 240:1, the yen has a U.S.-dollar value of about $.004167. ($.004167 x 24 million = $100,000.)

[18] ($.004545 x 24 million = $109,091.)

[19] The term "capital asset" includes all classes of property not specifically excluded by Section 1221 of the Code. Foreign currency generally falls within the definition of a capital asset; however, under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal language of section 1221 of the Code is not considered a capital asset if the property is used by a taxpayer as an integral part of a trade or business.

[20] *See, e.g., Kenan* v. *Commissioner*, 114 F.2d 217 (2d Cir. 1940) (where property was transferred in satisfaction of a legatee's claim against an estate); *Rogers* v. *Commissioner*, 103 F.2d 790 (9th Cir. 1939), cert. denied, 308 U.S. 580 (1939) (where property was transferred in return for cancellation of a note representing part of the purchase price); Rev. Rul. 76-111, 1976-1 C.B. 214. See also, *United States* v. *Davis*, 370 U.S. 65 (1962) (where property was transferred to a spouse to discharge marital claims; this particular result was reversed by the Deficit Reduction Act of 1984).

light of this authority, because foreign currency is treated as property, the IRS has taken the position that the transfer of foreign currency to pay a debt constitutes a sale or exchange. Thus, in the IRS's view, capital gain or loss results, unless the foreign currency was used by the borrower as an integral part of its ordinary trade or business under the *Corn Products* doctrine.[21]

The Sixth Circuit Court of Appeals, as well as the U.S. Tax Court (with seven dissents), rejected the IRS's view that repayment of a foreign currency loan constitutes a sale or exchange.[22] The Sixth Circuit relied on a 1939 case in which the U.S. Supreme Court held that the repayment of a debt is not considered a sale or exchange as to the creditor because the debtor does not receive property in the transaction.[23] Accordingly, because a sale or exchange is a prerequisite for capital gain or loss treatment, the Sixth Circuit held that an exchange loss on repayment of a foreign-currency denominated debt was an ordinary loss.

In an earlier case, the Sixth Circuit characterized exchange gain as income from the discharge of indebtedness.[24] Business taxpayers rely on this decision to defer the recognition of an exchange gain on repayment of a loan, by electing to reduce the basis of depreciable property by a corresponding amount (under sections 108 and 1017 of the Code), while immediately claiming exchange losses on similar transactions.

Finally, the borrowing and repayment of a foreign currency has been analogized to a "short sale" an analysis that supports capital gain or loss treatment unless the *Corn Products* doctrine applies.[25] In a short sale, the taxpayer sells borrowed property and later closes the short sale by returning identical property to the lender. Under section 1233(a) of the Code, gain or loss (computed by comparing the adjusted basis of the property used to close the short sale with the amount realized when the borrowed property was sold) is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer.

Source rules.—The source of an exchange gain or loss is important because of its impact on the calculation of the foreign tax credit limitation (as described more fully below, the amount of the credit is limited to the portion of U.S. tax liability that is attributable to foreign-source taxable income). Sections 861, 862, and 863 of the Code, and the accompanying regulations, provide rules for allocating income or gain to a domestic or a foreign source. Under the "title passage" rule (which is repealed by sec. 611 of the bill), gain from the sale of personal property generally is treated as foreign source if the property is sold outside the United States; however, the re-sourcing rule of section 904(b)(3)(C) of the Code could apply

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[21] See Rev. Rul. 78-396, 1978-2 C.B. 114; Rev. Rul. 78-281, 1978-2 C.B. 204; G.C.M. 39294 (June 15, 1984).

[22] *National-Standard*, 749 F.2d. 369 (6th Cir. 1984), aff'g 80 T.C. 551 (1983).

[23] *Fairbanks* v. *United States*, 306 U.S. 436 (1939), aff'g 95 F.2d 794 (9th Cir. 1938) (the result in the case was reversed by statute).

[24] *Kentucky & Indiana Terminal Railroad Co.* v. *United States*, 330 F.2d 520 (6th Cir. 1969). See also, *Gillin* v. *United States*, 423 F.2d 309 (Ct. Cl. 1970).

[25] See *National-Standard*, 80 T.C. at 567-568 (Judge Tannenwald's dissent).

to recharacterize a taxpayer's foreign source capital gain as domestic source gain for purposes of the foreign tax credit limitation.[26]

Losses from the disposition of capital assets or assets described in section 1231(b) of the Code (relating to property used in a trade or business) are sourced by reference to the source of the income to which the property ordinarily gives rise (Treas. reg. sec. 1.861-8(e)(7)). Otherwise, losses are generally allocated and apportioned between foreign and domestic gross income (*e.g.*, on the basis of the location of the taxpayer's property).

Treatment of creditors

If a taxpayer makes a loan of foreign currency and is repaid with appreciated or depreciated currency, the taxpayer will realize exchange gain or loss on the repayment.[27] Under section 1271 of the Code, amounts received by the holder on retirement of a debt instrument are treated as received in a sale or exchange. The character of the gain or loss depends on whether the debt instrument constitutes a capital asset in the hands of the holder.

Accounts payable or receivable

A U.S. taxpayer may agree to make or receive payment in a foreign currency for the sale of goods or the performance of services, thereby creating a foreign currency denominated account payable or account receivable, respectively. Foreign exchange gain or loss will arise if the value of the foreign currency appreciates or depreciates before the account is settled. Under the case law, exchange gain or loss arising from accounts payable or receivable is recognized at the time of payment.[28]

Character.—There is no legal significance whether foreign currency is borrowed from a third-party or borrowed, in effect, by credit extended by a seller.[29] Consistent with the *Corn Products* doctrine, exchange gain or loss attributable to the settlement of a trade payable or receivable is generally characterized as ordinary income or loss.[30]

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[26] Section 904(b)(3)(C) was designed to limit abuse of the "title passage" rule (*i.e.*, the making of sales abroad solely to generate foreign source gains and thereby increase the foreign tax credit limitation), and applies unless (1) personal property is sold by an individual in a foreign country where the individual was resident, (2) in the case of any taxpayer, the property was sold in a country in which the taxpayer derived more than 50 percent of its gross income for the three-year period preceding the sale, (3) a foreign tax of ten percent or more was paid on the sale or exchange, or (4) a corporation sells shares in a second corporation in the country in which the second corporation is resident, and the second corporation derived more than 50 percent of its gross income from that country during the preceding three-year period.

[27] *See KVP Sutherland Paper Co.* v. *United States*, 344 F.2d 377 (Ct. Cl. 1965). In *KVP Sutherland*, the court found three recognition events in a loan transaction: (1) the exchange of foreign currency for a note, (2) the receipt of foreign currency on repayment, and (3) the conversion of the foreign currency received on repayment to U.S. dollars.

[28] *See Bennett's Travel Bureau, Inc.*, 29 T.C. 198 (1956) (where the taxpayer accrued a deduction for accounts payable in Norwegian kroner but, in a later year, settled the account at less than the U.S.-dollar amount it had deducted); *Foundation Co.*, 14 T.C. 1333 (1950) (where the taxpayer performed services in Peru and accrued Peruvian soles, and the currency's value at the time of payment was lower than when the income was accrued).

[29] *See American-Southeast Asia Co., Inc.*, 26 T.C. 198, 201 (1956) (where the U.S. Tax Court considered this point).

[30] *See Church's English Shoes, Ltd.*, 24 T.C. 56 (1955), aff'd per curiam, 229 F.2d 957 (2d Cir. 1956) (where the taxpayer imported goods on credit, the purchase of foreign currency to settle the account payable was viewed as part of the taxpayer's ordinary business, and, thus, an exchange gain was taxable as ordinary income). See also, I.R.C. sec. 1221(4) (an account receivable acquired for services rendered or sales of property in the ordinary course of business is excluded from the definition of a capital asset).

Source of exchange gain or loss on accounts payable or receivable.—Applicable rules generally source income from the sale of inventory under the title passage test. Similarly, income from the performance of services is sourced by reference to the place where the services were performed. As noted above, losses are generally allocated and apportioned between domestic and foreign sources. In view of the separate transactions principle, however, it is unclear whether exchange gain or loss on settlement of an account relating to the sale of inventory or the performance of services would be sourced under the general sourcing rules discussed above.

Interest on foreign currency denominated debt

Rules of general application.—Normally, a debt instrument is issued at a price approximately equal to the amount that will be received by the lender at maturity, and the return to the lender is entirely in the form of periodic interest payments. In the case of a debt instrument that is issued at a discount, the issue price is less than the amount to be repaid to the lender, and the lender receives some or all of the return in the form of price appreciation. The original issue discount ("OID") is functionally equivalent to an increase in the stated rate of interest, *i.e.*, OID compensates the lender for the use of the borrowed funds. If a debt instrument is issued at a premium, the issue price is more than the amount to be repaid to the lender.

In general, interest is includible in the lender's income (and deductible by the borrower) when paid or accrued. The issuer of an OID instrument is allowed deductions for, and the holder of the instrument is required to include in income, the daily portions of OID determined for each day of the taxable year the instrument is held (secs. 163(e) and 1272). If an instrument is issued at a premium, the premium is treated as income that must be prorated or amortized over the life of the instrument (Treas. reg. sec. 1.61-13(c)). The holder of an instrument issued at a premium can elect to deduct equal annual amounts over the life of the obligation (sec. 171).

Amortization of OID or premium.—The rules for amortizing OID parallel the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds (under the constant yield method).[31]

OID is allocated over the term of a debt instrument through a series of adjustments to the issue price for each accrual period (generally, each six-month—or shorter—period determined by reference to the date six months before the maturity date). The adjustment to the issue price for each accrual period is determined by multiplying the issue price (as increased by prior adjustments) by the instrument's yield to maturity, and then subtracting the interest actually payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocat-

[31] Essentially, the borrower is treated as paying the lender the annual interest accruing on the outstanding principal balance, which interest is deductible by the borrower and includible in the income of the lender, and the lender is deemed to lend the same amount back to the borrower. Thereafter, the borrower is deemed to pay interest on the unpaid interest as well as the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the economic accrual of interest or compounding.

ed to that accrual period. Although the economic arguments underlying the treatment of OID are equally applicable to premium, taxpayers are not required to use the constant yield method to amortize premium (a result that is reversed by sec. 1503 of the bill).

Measurement of interest income and deductions in deferred payment transactions.—Prior to 1984, the OID provisions did not apply to an obligation issued for nonpublicly traded property where the obligation itself was not publicly traded. The principal reason for this exception was the perceived difficulty in determining the value of nonpublicly traded property, and hence the issue price of (and the amount of OID implicit in) the obligation. Congress addressed this valuation problem by providing objective rules that prescribe an issue price for an obligation issued for nonpublicly traded property (sec. 1274).

Section 1274 performs two roles: (1) testing the adequacy of stated interest, and, where stated interest is inadequate, recharacterizing a portion of the principal amount as interest, and (2) prescribing the issue price. If the prescribed issue price is less than the debt instrument's stated redemption price at maturity, the differential is treated as OID. These calculations are made by reference to the "applicable Federal rate" (generally, the average yield on marketable obligations of the U.S. government with a comparable maturity, referred to as the "AFR").

Under a literal reading of section 1274, an obligation issued for foreign currency is subject to the rules for deferred payment transactions.

Treatment of market discount.—A market discount bond is an obligation that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued OID, in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance, typically, because of an increase in prevailing interest rates or decline in the credit worthiness of the borrower. Gain on disposition of a market discount bond is recognized as interest income, to the extent of accrued market discount (generally computed under a linear formula, although a taxpayer can elect to use the constant yield method described above). Accrued market discount is not treated as interest for purposes of withholding at source, information reporting requirements, or such other purposes as the Secretary may specify in regulations.

Thirty-percent withholding.—In certain cases, U.S.-source interest income received by a nonresident foreign person is subject to a flat 30-percent tax on the gross amount paid, subject to reduction in rate or exemption by tax treaties to which the United States is a party (secs. 871(a) and 881).[32] The tax is generally collected by means of withholding by the person making the payment to the foreign recipient (secs. 1441 and 1442). The 30-percent tax is inapplicable if the interest is effectively connected with a U.S. trade or business of the foreign recipient; instead, the income is reported on a U.S. income tax return and taxed at the rates that apply to U.S.

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[32] The 30-percent withholding tax also applies to other fixed or determinable annual or periodical income from U.S. sources.

persons. The 30-percent tax is inapplicable to interest paid by a U.S. borrower on certain portfolio debt and other investments.

Source of U.S. taxpayer's interest expense.—A U.S. taxpayer's deduction for interest expense is generally apportioned between domestic and foreign source gross income in proportion to the borrower's domestic and foreign assets, or, within limits, domestic and foreign source gross income (Treas. reg. sec. 1.861-8(e)(2)). (Section 614 of the bill prohibits apportionment on the basis of gross income.)

Hedging transactions

A U.S. taxpayer can "hedge" against changes in the dollar value of (1) foreign-currency denominated assets and liabilities.

Example (2).—In example (1), above, where a U.S. taxpayer borrows 24 million yen when the exchange rate is 240:1, the borrower could hedge against a potential exchange loss (i.e., protect itself against possible appreciation in the value of the yen to be repaid) by entering into a "forward contract" (defined below) to purchase at the maturity of the loan, 24 million yen a predetermined exchange rate.

If the exchange rate rose to 220:1, the borrower could obtain yen under the forward contract at the lower 240:1 rate, and save $9,091 (the additional $9,091 that would have been required to purchase 24 million yen at the current rate, less the $2,000 premium).

If the exchange rate fell to 260:1, the borrower would still be obligated to purchase yen at the rate specified in the forward contract, although the obligation could be terminated by making a cash payment.

The U.S. tax consequences of a transaction that is undertaken to hedge foreign exchange exposure turn, in large part, on (1) the nature of the financial product used to effect the hedge, and (2) whether the hedging transaction relates to the taxpayer's own business operations or the business operations of an affiliate. Further, different tax rates could apply to the positions included in a hedging transaction, with the result that a transaction that produces no economic gain or loss could result in an after-tax profit or loss.

Description of certain financial products

A variety of financial products are available for use in reducing the impact of exchange rate fluctuations on foreign-currency denominated assets or liabilities.

Forward contracts.—Trading in foreign currency is conducted in an informal interbank market through negotiated forward contracts. A forward contract calls for delivery or purchase of a specified amount of foreign currency at a future date, with the exchange rate fixed when the contract is made. Forward exchange rates (*i.e.*, premiums or discounts) are determined by reference to interest rate differentials in the interbank deposit market. The currency with the lower interest rate trades at a higher forward price than the spot rate (*i.e.*, at a "forward premium"); the difference between the spot rate and the forward price of the currency trading at a higher interest rate is referred to as a "forward discount."

Example (3) (pricing a forward contract).—Assume that the three-month deposit rate for Deutsche marks is 8 percent compounded

quarterly (for a three-month yield of 2 percent), and the three-month deposit rate for U.S. dollars is 10 percent compounded quarterly (for a three-month yield of 2 1/2 percent). The spot rate for Deutsche marks is 2.1 (i.e., DM2.1 = $1). If the forward exchange market is perfectly efficient, the forward exchange rate for Deutsche marks should be 2.0898, determined according to the following formula:

$$\frac{DM2.1\ ^{1} \times 1.02\ ^{2}}{\$1 \times 1.025\ ^{2}} = 2.0898$$

[1] The spot rate.
[2] One plus the interest rate.

Thus, a taxpayer who requires Deutsche marks in three months time (e.g., to settle an account payable) can either purchase Deutsche marks at the spot rate and deposit them, or enter into a forward purchase contract, and obtain approximately the same results. The taxpayer's choice would be influenced by whether the taxpayer expects the Deutsche mark to appreciate by an amount that is greater or lesser than the premium.

Regulated futures contract.—A futures contract is a standardized forward contract to sell or purchase a specified amount of foreign currency during a designated month in the future. A regulated futures contract ("RFC") is defined for purposes of section 1256 of the Code (discussed below) as a contract that is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading commission (or any board of trade or exchange approved by the Treasury Department), and that is "marked to market" (defined below in the discussion of section 1256 of the Code) under a cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains (as the result of price changes with respect to the contract). The utility of futures contracts as hedging tools is limited, primarily because contracts in excess of 12 months are difficult to obtain.

A variety of foreign currency futures (covering, for example, Deutsche marks, British pounds, and Japanese yen) are traded on the New York Futures Exchange and the International Monetary Market of the Chicago Mercantile Exchange, to name but several exchanges.

Foreign currency options.—A foreign currency option is a contract under which the "writer" grants the "holder" the right to purchase or sell the underlying currency for a specified price during the option period. The consideration (or premium) for option rights is paid at acquisition, and the holder has no further obligations under the option unless or until the option is exercised. Foreign currency options are written by banks, as well as traded publicly on exchanges such as the Chicago Mercantile Exchange and the Philadelphia Stock Exchange.

Example (4).—On the facts of example (2), above, instead of entering into a forward contract, the borrower could acquire an option to purchase 24 million yen at 240 yen per dollar. In such a case, if the yen:dollar exchange rate falls to 260:1, the option could be allowed to expire unexercised, and the 24 million yen could be acquired at the lower current rate.

Parallel loans.—In a parallel (or back-to-back) loan transaction, a U.S. taxpayer lends U.S. dollars to a foreign person, and, contemporaneously, the foreign person lends foreign currency of equal value to the U.S. taxpayer. The terms of the loan agreements are substantially identical, and both loans mature on the same date.

Currency swaps.—Currency swaps were developed as an alternative to parallel loans. A currency swap generally involves an exchange of U.S. dollars for foreign currency at the spot rate, coupled with an agreement to reverse the transaction on a future date at the original exchange rate. A swap can be structured so that there is no actual exchange of currencies; the parties to the swap can simply agree to make payments to each other (i.e., to swap the interest and principal payments).

Interest rate swaps.—In an interest rate swap, the parties agree to make periodic payments to each other, the amounts of which are determined by reference to a prescribed principal amount. Typically, an interest rate swap involves a borrower with access to fixed-rate debt and another borrower with access to floating-rate debt. In a cross-currency interest rate swap, each party pays the other an amount determined by reference to the recipient's interest rate.

Although the swap payments are measured by interest payments, they are not viewed as interest because they are not paid as compensation for the use or forbearance of money.

Application of provisions relating to tax straddles

Specific statutory rules prevent the use of "straddles" to defer income or to convert ordinary income (or short-term capital gain) to long-term capital gain. In general, a tax straddle is defined as offsetting "positions" with respect to personal property (sec. 1092(c)). The term position is generally defined as an interest (including a futures or forward contract) in personal property of a type that is actively traded. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property.

By their terms, the tax straddle rules apply to most transactions undertaken to hedge foreign exchange exposure, unless the transaction generates only ordinary income or loss (and otherwise satisfies the requirements of the statutory hedging exemption described below).

Loss deferral rule.—If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over any unrecognized gain in offsetting positions (sec. 1092(a)). In addition, taxpayers are required to capitalize otherwise deductible expenditures for property that is part of a straddle, except to the extent of income received with respect to the property (sec. 263(g)).

Mark-to-market rules.—An RFC or a nonequity option that is traded on (or subject to the rules of) a qualified board of trade or exchange (including a foreign currency option) and that is held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Positions that are subject to mark-to-market treatment are referred to as section 1256 contracts. Any gain or loss on a section 1256 contract is generally treated as 40-percent short-term capital gain or loss and 60-percent long-term capital gain or loss. For purposes of these rules, a foreign currency forward contract is treated as a section 1256 contract, if the contract is traded in the inter-bank market, and (3) is entered into at an arm's length price determined by reference to the price in the inter-bank market (sec. 1256(g)).

Mixed straddles.—In general, the loss deferral rule applies to a straddle composed of both section 1256 contracts and positions that are not marked-to-market. The section 1256 contracts in a mixed straddle are excluded from the mark-to-market rules if the taxpayer designates the positions as a mixed straddle by the close of the day on which the first section 1256 contract is acquired.

Assume that a foreign-currency denominated loan is offset by a forward purchase contract that is subject to the mark-to-market rule (which could occur if no mixed straddle election were made). Assume further that the taxpayer uses the loan proceeds to make an investment. If the forward contract is marked to market at a loss (because the currency depreciated), the loss would be deferred until the offsetting gain attributable to the loan is recognized. On repayment of the loan, the taxpayer would realize capital gain that is offset by 60/40 loss attributable to the forward contract. Assuming the capital gain is short-term (because the currency was acquired shortly before its use to repay the loan), the 60/40 loss could result in the conversion of unrelated long-term capital gain to short-term capital gain. This would occur because 40 percent of the loss on the forward contract would offset 40 percent of the short-term capital gain, and 60 percent would be applied first to the taxpayer's long-term capital gain from the unrelated transaction, leaving 60 percent of the short-term gain on the loan repayment.

Taxpayers can avoid these results by making a mixed straddle election and foregoing mark-to-market and 60/40 gain treatment. A taxpayer may fail to make a timely election, however, because of uncertainty in determining whether positions in foreign currency are part of a straddle, or because offsetting positions are established inadvertently.

Termination of rights under a forward contract.—Gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property is treated as capital gain or loss, except in the case of the retirement of a debt instrument (sec. 1234A). Property subject to this rule is any personal property of a type that is actively traded and that is (or would be on acquisition) a capital asset in the hands of the taxpayer. Thus, the settlement of a foreign-currency forward contract would generate capital gain or loss unless the *Corn Products* doctrine applies, regardless of the manner in which the contract is terminated.

Hedging exception.—Certain hedging transactions are exempt from the loss deferral, mark-to-market, and capitalization rules (secs. 1092(e) and 1256(e)). For purposes of this exception, a hedging transaction is generally defined as a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and results only in ordinary income or loss. Under a special rule for banks (as defined in section 581), a bank's transactions need not satisfy the primary purpose requirements applicable to other taxpayers. This hedging exception applies to a transaction that reduces the risk of (1) price change or foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) interest rate or price changes, or foreign currency exchange rate fluctuations with respect to borrowings or obligations of the taxpayer. For purposes of these rules, a hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Related provisions: short sale rules of section 1233.—Present law provides rules that are designed to eliminate specific devices in which short sales could be used to transform short-term capital gain into long-term capital gain, or long-term capital loss into short-term capital loss (sec. 1233(b) and (d)). The rules are stated to apply to stock, securities, and commodity futures, but not to hedging transactions in commodity futures (sec. 1233(e)). Under these rules, if a taxpayer holds property for less than the period required for long-term capital gain treatment, and sells short substantially identical property, any gain on closing the short sale is considered short-term capital gain and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)).

There are several cases that support the position that section 1233(b) is inapplicable to the sale of a foreign currency forward contract.[33] The IRS, however, has taken a contrary view.[34]

Hedges relating to foreign subsidiaries

Under the case law, the *Corn Products* doctrine is applied to hedging transactions only if the hedge relates to the taxpayer's "own" day-to-day business operations. Thus, a hedging transaction with respect to the separate operations of a foreign subsidiary corporation is not treated as falling within the doctrine.[35]

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[33] *American Home Products Co.* v. *United States*, 601 F.2d 540 (Ct. Cl. 1979); *Carborundum Co.*, 74 T.C. 730 (1980).

[34] Technical Advice Memorandum 8016004 (December 18, 1979). Although a technical advice memorandum is not binding as precedent on the IRS or the courts, a technical advice memorandum is helpful in interpreting the law in the absence of clear authority.

[35] *International Flavors & Fragrances*, 62 T.C. 232 (1974), rev'd and rem'd, 524 F.2d 357 (2d Cir. 1975), on remand, 36 T.C.M. 260 (1977) (taxpayer sold British pounds short to hedge net asset position of U.K. subsidiary); *The Hoover Co.*, 72 T.C. 206 (1979) (taxpayer entered into forward contracts to offset potential decline in value of stock in a foreign subsidiary), nonacq., 1980-1 C.B. 2 (the nonacquiescence relates to the court's holding that Hoover's sale of a forward purchase contract for foreign currency shortly before the time set for performance—but after the currency was devalued—resulted in long-term capital gain; the IRS's concern was based on the fact that short-term capital gain would have resulted if the taxpayer had accepted delivery under the contract and then exchanged the foreign currency).

Foreign currency translation

Under present law, a taxpayer operating abroad is permitted to maintain the books and records of operation in a foreign currency. The method of translating the results of the taxpayer's foreign operation depends on whether the activity is conducted through a branch or through a subsidiary corporation. Additional requirements are imposed if the taxpayer operates through a subsidiary that is a "controlled foreign corporation" (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own 10 percent or more of such stock, referred to as a "CFC"). (Section 622 of the bill amends the definition of a CFC.)

Present law does not prescribe criteria for use in determining when it is appropriate to record the results of a foreign operation in a foreign currency. Furthermore, for the most part, the method used to translate foreign currency results into U.S. dollars is left to the taxpayer's discretion. The recognized translation methods can produce substantially different U.S. tax consequences.

Branches

A foreign branch that maintains a separate set of books in a foreign currency can use either a "profit and loss" or a "net worth" method to determine U.S. taxable income attributable to the branch operation.[36]

Under the profit and loss method, the net profit computed in the foreign currency is translated into dollars at the exchange rate in effect at the end of the taxable year. If the branch made remittances during the year, these amounts are translated into U.S.-dollars at the exchange rate in effect on the date remitted, and only the balance of the profit, if any, is translated at the year-end exchange rate.

Under the net worth method, U.S. taxable income is defined generally as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year. Under this method, the branch's balance sheet is translated into U.S. dollars. In general, the values of current assets and liabilities are translated at the year-end exchange rate, and fixed (long-term) assets are translated at the exchange rate in effect on the date the asset was acquired (the "historical rate"). The translation of an item at its historical rate defers recognition of exchange gain or loss. Remittances are translated at the exchange rate in effect on the date of remittance, and are then added to the U.S.-dollar amount computed by comparing year-end balance sheets.

The choice of a method for translating the income of a branch is viewed as a method of accounting, and, thus, cannot be changed without the consent of the Secretary.[37] The profit and loss and net worth methods produce different results, primarily because changes in the values of current assets and liabilities are taken into account annually under the net worth method, but not under the profit and loss method.

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[36] See Rev. Rul. 75-107, 1975-1 C.B. 32 (relating to the profit and loss method); and Rev. Rul. 75-106, 1975-1 C.B. 31, and Rev. Rul. 75-134, 1975-1 C.B. 33 (relating to the net worth method).

[37] *See American Pad & Textile Co.*, 16 T.C. 1304 (1951), acq., 1951-2 C.B. 1.

When a foreign branch remits currency in excess of the current year's profit, the basis of the excess amount must be determined in order to calculate exchange gain or loss. Present law does not provide explicit rules for calculating exchange gain or loss on remittances.

Distributions from foreign corporations

A domestic corporation is subject to tax on its worldwide income. Foreign corporations generally are taxed by the United States only on income that is effectively connected with a U.S. trade or business and on certain passive income from U.S. sources. As a result, under the general rules, income derived by a U.S. person through a foreign corporation operating abroad is not subject to tax unless and until the income is distributed to U.S. shareholders. An exception to the general rule of deferral is provided by the subpart F provisions of the Code (secs. 951-964), under which income from certain tax-haven type activities currently is taxed to certain U.S. shareholders of CFCs.

Controlled foreign corporations

The "subpart F" income of a CFC is taxed to "U.S. shareholders" as a constructive dividend, to the extent of post-1962 earnings and profits (secs. 951 and 952(c)). The term "U.S. shareholder" is generally defined as a U.S. person who owns 10 percent or more of a CFC's voting stock (sec. 951(b)). "Subpart F" income generally includes income from (1) related-party sales and services transactions through tax-haven base companies, (2) the insurance of U.S. risks, (3) shipping operations (unless the income is reinvested), (4) oil related activities, and (5) passive investments (sec. 952) (sec. 621 of the bill expands the definition of subpart F income). A loan with a term of more than one year from a CFC to a related U.S. person generally is treated as an investment in U.S. property (sec. 956), with the result that the amount of the loan is treated as a constructive distribution to U.S. shareholders under the subpart F provisions (sec. 951(a)(1)(B)). A constructive distribution under subpart F includes a pro rata portion of the CFC's exchange gain or loss.

Applicable Treasury regulations provide rules for translating a CFC's earnings and profits and subpart F income (Treas. reg. secs. 1.964-1(a)-(e)). Under the subpart F method of translation, earnings and profits are calculated by computing the sum of the CFC's profit or loss plus the gain or loss determined by comparing the CFC's balance sheet (referred to as the "full subpart F method"). The earnings and profits so computed are translated at an "appropriate rate of exchange" (generally, a monthly average of the exchange rates in effect for the taxable year).[38]

Gain from sale or exchange of stock in certain foreign corporations

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. shareholder (as defined above) is recharacterized

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[38] *See* Treas. reg. sec. 1.964-1(d)(2). If the value of the relevant currency fluctuates substantially during the year, the appropriate rate of exchange might be a weighted monthly average, depending on whether that rate more closely approximates the results of translating individual transactions at the exchange rates in effect when the transactions occurred.

as dividend income, to the extent of the foreign's corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a CFC (sec. 1248). For purposes of computing the section 1248 constructive dividend, a foreign corporation's earnings and profits are translated into U.S. dollars under the full subpart F method (described above) (Treas. reg. sec. 1.1248-2(d)(2)).

Computation of foreign tax credit

In general, a credit against U.S. tax liability is allowed for foreign income taxes paid or accrued with respect to foreign-source income (sec. 901). The purpose of the foreign tax credit generally is stated to be to mitigate the effects of double taxation of income that is subject to tax by both the United States and a foreign government. The allowable foreign tax credit for a taxable year is limited to U.S. tax liability multiplied by a fraction the numerator of which is foreign-source taxable income and the denominator of which is worldwide taxable income (sec. 904(a)).

For purposes of section 901 of the Code, foreign taxes are deemed paid with respect to dividends received by a U.S. corporation that owns at least 10 percent of the voting stock of the distributing foreign corporation (sec. 902). Similarly, foreign taxes are deemed paid with respect to Subpart F constructive dividends (sec. 960). Thus, these dividends carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

Direct credit

In the case of foreign taxes paid on income derived directly through branch operations, taxpayers generally are required to translate the foreign taxes into U.S. dollars at the exchange rate in effect on the date such taxes were paid or accrued.[39] If the amount of foreign taxes accrued differs from the amount paid, or if a foreign tax is refunded (in whole or in part), a taxpayer must notify the IRS, and redetermine the allowable credit for the taxable year (sec. 905(c)). The rule requiring an adjustment upon the payment of accrued foreign taxes is applied by comparing the U.S.-dollar value of the amount accrued to the U.S.-dollar value of the amount actually paid.[40] Thus, with respect to foreign taxes that are accrued but not paid, subsequent exchange rate fluctuations are taken into account under section 905(c) of the Code.

If a foreign tax is refunded, under the case law, taxpayers are permitted to redetermine the allowable credit by translating the foreign refund into U.S. dollars at the rate of exchange in effect on the date of refund.[41]

Example (5) (refund of foreign tax).—Assume that a taxpayer pays a 10,000 Swiss franc tax when one franc is equal to $.50 (so the U.S.-dollar cost would be $5,000). In a later year, the entire 10,000 franc tax is refunded when one franc is equal to $.40 (so the U.S.-dollar value of the refund is only $4,000). Under the relevant

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[39] Rev. Rul. 73-491, 1973-2 C.B. 268.

[40] *First Nat'l City Bank* v. *United States*, 557 F.2d 1379 (Ct. Cl. 1977); *Comprehensive Designers International Ltd.*, 66 T.C. 348 (1976); Rev. Rul. 73-506, 1973-2 C.B. 268.

[41] *American Telephone & Telegraph* v. *United States*, 430 F. Supp. 172 (S.D.N.Y. 1977), aff'd 567 F.2d 554 (2d Cir. 1978) Rev. Rul 58-237, 1958-1 C.B. 534.

authorities, a $1,000 tax would be eligible for credit even though the foreign tax was refunded.

Indirect credits

To calculate the amount of foreign taxes deemed paid under section 902 of the Code, the amount of foreign taxes paid with respect to the earnings out of which the distribution is made is multiplied by a fraction, the numerator of which is the amount of the dividend and the denominator of which is the amount of the accumulated profits out of which the dividend was paid (referred to as the "section 902 fraction") (sec. 902(a)).

To calculate the amount of foreign taxes deemed paid under section 960 of the Code, foreign taxes paid are multiplied by a fraction, the numerator of which is the Subpart F income and the denominator of which is the CFC's earnings and profits (referred to as the "section 960 fraction").

Actual distributions.—In the case of an actual distribution, the regulations promulgated under section 902 of the Code provide that accumulated profits denominated in a foreign currency are translated into U.S. dollars at the exchange rate in effect on the date the dividend is distributed (Treas. Reg. sec. 1.902-1(g)(1)). At the taxpayer's election, accumulated profits are computed under the profit and loss method prescribed by the regulations promulgated under section 964 (referred to as the "limited subpart F method," because there is no requirement that the balance sheet be translated) (Treas. reg. sec. 1.902-1(g)(2)). In addition, under the authority of the *Bon Ami Co.* case, the amount of the dividend and the foreign taxes deemed paid are also translated at the exchange rate in effect on the date of distribution.[42] The use of the current exchange rate to translate foreign taxes deemed paid effectively negates section 905(c) of the Code. These rules also apply to constructive dividends under section 1248 (Treas. reg. sec. 1.1248-1(d)(1)).

In the case of a constructive dividend under section 1248, under a literal reading of the applicable regulations, the amount of the dividend in the section 902 fraction is translated under the full subpart F method at an average exchange rate, while accumulated profits and foreign taxes are translated at the exchange rate in effect on the date of the deemed dividend under section 1248.[43]

Example (6).—Assume that a French subsidiary corporation has accumulated profits of 400 French francs before French tax and that a French tax of 100 was paid. Assume further that the profits were earned, and the tax paid, when the French franc was worth $.20. Thus, a French tax with a value of $20 was paid with respect to $80 of income, resulting in an effective tax rate of 25 percent. If the earnings are distributed after the franc's value has fallen to

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[42] 39 B.T.A. 825 (1939) (a case decided under the predecessor to section 902 of the Code). *But, see American Metal Co.*, 221 F.2d 134, 141 (2d Cir. 1955) (when the foreign corporation keeps its books in U.S. dollars, foreign taxes are translated as of payment date).

[43] *But see G.C.M.* 37133, (May 24, 1977) (concluding that accumulated profits should also be determined under the full subpart F method). Although a G.C.M. is not binding as a precedent on the IRS or the courts, a G.C.M. is helpful in interpreting the law in the absence of clear authority. *See also*, D. Ravenscroft, Taxation and Foreign Currency 627 (1973) (for an argument that the numerator in the section 902 fraction could be determined under the limited subpart F method, since the full subpart F method of determining earnings and profits is only a limitation on the amount that can be treated as a section 1248 dividend).

$.10, the parent corporation would be deemed to have paid $10 of French tax ($30/$30 x $10).[44] If the franc's value rose to $.25, the parent corporation would be deemed to have paid $25 of French tax ($75/$75 x $25). In either case, the amount of French tax eligible for credit would equal 25 percent of the U.S.-dollar value of the accumulated profits before tax; however, the U.S.-dollar cost of the French tax paid would be understated or overstated, depending on whether the franc's value depreciated or appreciated.

Subpart F constructive dividends.—The full subpart F method is mandated for purposes of computing the deemed-paid credit under section 960 of the Code. Thus, because the balance sheet is translated, exchange gain or loss on current assets is taken into account in computing earnings and profits for purposes of the section 960 fraction.

For a CFC that incurs a net exchange loss, the application of the full subpart F method can produce a more favorable result for the taxpayer. This is because taking exchange losses into account reduces earnings and profits (the denominator of the section 960 fraction), and thereby increases the allowable deemed-paid foreign tax credit. Under present law, a taxpayer whose CFC has a net exchange loss, but no subpart F income, can effectively elect to use the full subpart F method to increase the deemed-paid credit. This result can be accomplished by repatriating earnings in the form of subpart F income, instead of having the CFC make an actual dividend distribution. Subpart F income can be triggered (and earnings repatriated), for example, by having a CFC make a loan that extends for more than one year to a U.S. shareholder.

Related financial accounting standards

There was no uniform system of accounting for foreign currency transactions prescribed by the accounting profession prior to the issuance of Statement of Financial Accounting Standards No. 8 ("FASB 8") by the Financial Accounting Standards Board. FASB 8, which was issued in 1975 effective for fiscal years beginning on or after January 1, 1976, generally required the inclusion of exchange gain or loss in net income for financial reporting purposes.

In 1981, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 52 ("FASB 52"), relating to foreign currency translation, for application to foreign currency transactions and financial statements of foreign entities (including branches and subsidiaries). FASB 52 introduced the "functional currency" approach, under which the currency of the economic environment in which a foreign entity operates generally is used as the unit of measure for exchange gains and losses. Under FASB 52, in most cases, exchange gain or loss is treated as an adjustment to shareholders equity, and not as an adjustment to net income. In defining a "reporting enterprise," FASB 52 distinguishes a "self-contained" operation from an operation that is an integral extension of a U.S. operation; in the latter case, the indicated functional currency is the U.S. dollar.

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[44] The after-tax accumulated profits are included in the denominator (300 x $.10 = $30).

Reasons for Change

Present law is unclear regarding the timing of recognition, the character, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. Further, present law does not prescribe rules for determining when the results of a foreign operation can be recorded in a foreign currency, and the method used to translate foreign-currency results into U.S. dollars is left to the taxpayer's discretion. After reviewing this state of affairs, the Committee determined that it is necessary to provide a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currency.

Functional currency

The committee believes it is desirable to provide objective and consistent criteria for determining when a taxpayer may maintain books and records for U.S. tax purposes in a foreign currency. Together with the appropriate translation method discussed below, the use of a "functional currency" in maintaining books and records of operations will enable taxpayers to account for taxable income and related foreign taxes generated from foreign operations on a consistent basis. The committee's bill provides that each taxpayer (or qualified business unit thereof) must identify and adopt a functional currency for maintaining its books and records, and for computing its taxable income, foreign taxes, earnings and profits, and other income, deductions, and credits.

Foreign currency transactions

The lack of a coherent set of rules for the treatment of foreign currency transactions results in uncertainty. The courts have addressed several issues by applying general Federal income tax rules that produce anomalous results when applied to exchange gain or loss (e.g., the treatment of exchange gain on repayment of a loan as income from discharge of indebtedness that is eligible for deferral). Other issues are treated by old cases that are inconsistent with current case law, but that have not been expressly overruled (e.g., whether exchange gain or loss is integrated with gain or loss from an underlying transaction). Further, the IRS and the courts have taken contrary positions with respect to certain issues (e.g., whether a debtor's exchange gain or loss on repayment of a loan is capital or ordinary in nature). This state of affairs enables taxpayers to claim inconsistent tax treatment for similar transactions, relying on whichever authority provides the most advantageous result.

Debt denominated in a foreign currency

The authorities relating to a debtor's exchange gain or loss on repayment of a foreign currency loan may provide a basis for claiming capital gains and ordinary losses. Further, in the case of business taxpayers, it is possible to claim that exchange gain is eligible for deferral as income from discharge of indebtedness. The rules regarding the source of an exchange gain or loss on repayment of a debt are unclear; although one reading of the law results in domestic source gain and foreign source loss in certain cases.

Sourcing rules

Under the general source rules, gain on repayment of a foreign currency loan could be viewed as either foreign source (if ordinary in nature) or domestic source (if the repayment constitutes a sale or exchange and section 904(b)(3)(C) of the Code applies). The source of a loss on repayment is even less clear. Commentators have suggested the following possibilities: (1) exchange loss could be apportioned between domestic and foreign source income in the proportions that these amounts bear to each other in the aggregate, (2) an analogue to the "title passage" rule could apply to support treatment as foreign source, or (3) the source of the loss could be determined by reference to the source of the gain or loss from the underlying transaction. The committee determined that the overriding consideration should be to provide certainty regarding the source of exchange gain or loss. The bill accomplishes this result by sourcing exchange gain or loss in the same manner as interest income or expense is sourced.

Multi-currency contracts

Commentators have suggested that adverse U.S. tax consequences can be avoided by arranging to repay a foreign-currency denominated loan in U.S. dollars equivalent in value at repayment to the foreign currency borrowed.[45] In recent years, foreign lenders and U.S. borrowers have utilized a form of debt security under which the lender may dictate the currency in which repayment is to be made. By way of example, it is argued that characterization of an exchange loss on a loan repayment as a capital loss would be avoided if the loan is repaid in U.S dollars, since repayment with U.S. dollars would not involve a sale or exchange. This view ignores the economic reality that the resulting gain or loss would still be attributable to the value of the foreign currency borrowed.[46] The bill makes clear that the economic substance of a foreign-currency denominated transaction is determinative of the U.S. tax consequences.

Effect of exchange gain or loss on interest denominated in a foreign currency

Commentators have observed that a loan denominated in a foreign currency may reflect a "true" U.S.-dollar interest rate plus an anticipated annual exchange gain or loss.[47] For example, a U.S. taxpayer who borrows a currency that is viewed as strong in relation to the dollar would pay less interest than if the taxpayer had borrowed dollars (because the lender expects to be repaid with ap-

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[45] Committee on Foreign Activities of U.S. Taxpayers, Section of Taxation, American Bar Association, Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses, 36 Tax L. Rev. 425, 441 (1981). For a contrary view, see *Newman*, "Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft," 36 Tax Lawyer 223, 236 (1983).

[46] *See American Air Filter Co.*, 81 T.C. 709 (1983) (where a loan agreement provided that a liability payable in foreign currency could be converted to one payable in another currency, the conversion to a U.S.-dollar liability was treated as a realization event); G.C.M. 39294 (June 15, 1984) (where the IRS noted that repayment in U.S. dollars instead of foreign currency does not alter the tax consequences).

[47] *See, e.g.*, New York State Bar Association's Ad Hoc Committee on Original Issue Discount and Coupon Stripping, "Preliminary Report on Issues to be Addressed in Regulations and Corrective Legislation," Tax Notes, March 5, 1984, pp. 993-1034.

preciated currency). Conversely, if the taxpayer obtains a loan denominated in the currency of a country experiencing high rates of inflation, so that the currency is viewed as weak in relation to the dollar, the taxpayer would pay more annual interest than if dollars had been borrowed. In such cases, at least to the extent the parties' expectations prove to be correct, or the parties hedge their positions, it is arguable that nominal interest is understated or overstated, respectively. This perceived problem exists with respect to foreign currency loans issued at a premium or discount, as well as loans with stated interest. Proponents of this view of foreign-currency transactions assert that a taxpayer's interest income or expense should be adjusted (upwards or downwards) to reflect the "true" borrowing cost. It is also said that the current accrual of exchange gain or loss on a borrowing would properly allocate the additional "interest" to each year the borrowing is outstanding, to match income and expense.

Character of exchange gain or loss

The committee concluded that characterizing exchange gain or loss as interest income or expense for most purposes is a pragmatic solution to an issue about which tax scholars and practitioners hold disparate views. This conclusion is justified by the relationship between the dollar price of foreign currency in the forward market and the market interest rate for such currency relative to the dollar.

On the other hand, the committee was not persuaded that exchange gain or loss should be currently accrued in most cases. Because a right to receive (or an obligation to pay) foreign currency is not a right (or obligation) to receive (or pay) a fixed number of dollars, it would be problematical to require income inclusions (or permit deductions) due to exchange gain or loss that could be lost through subsequent exchange rate fluctuations.

The committee considered whether only unanticipated exchange gain or loss on a financial asset or liability should be characterized as capital gain or loss and taxed on realization. This approach was not followed because it is difficult to distinguish anticipated exchange gain or loss from unanticipated exchange gain or loss. Anticipated gain or loss could be measured with reference to the premium or discount element in a forward contract had one been obtained; however, forward contracts are not available in all currencies and do not trade at all maturities.

In two cases, the committee concluded that there should be exceptions from the general treatment of exchange gain or loss under the bill: (1) assuming appropriate safeguards are developed, exchange gain or loss should be accrued currently in the case of certain hedging transactions that in substance are equivalent to U.S.-dollar denominated assets or liabilities, and (2) given the special considerations underlying the mark-to-market rules of section 1256 and the loss-deferral rules of section 1092, gain or loss on foreign-currency denominated section 1256 contracts that are not a part of a hedging transaction should be excluded from the rules provided by the bill.

Other issues

There is a question under present law as to whether swap payments made by a U.S. taxpayer constitute U.S.-source "fixed or determinable annual or periodical income," and, thus, are subject to 30-percent withholding. A related issue is whether an exemption from withholding is available under an income tax treaty to which the United States is a party on the ground that swap payments constitute: (1) "industrial and commercial profits" not attributable to a permanent establishment, or (2) in the case of the U.K. and several other treaties, "other income" that is taxable only by the country of the recipient's domicile. These issues also arise with respect to currency swaps.

Further, present law does not provide sufficient guidance with respect to the treatment of discount or premium on foreign-currency denominated obligations. For example, it is unclear whether OID is computed by reference to the U.S.-dollar value of a foreign currency at the time an obligation is issued, or is computed in terms of the foreign currency and translated into dollars at the average value in each year that OID accrues.

Straddle rules

Taxpayers take the position that there is uncertainty in determining whether certain hedging transactions constitute straddles. For example, taxpayers question whether a currency swap constitutes a straddle if the risk of loss on a foreign currency loan is diminished thereby.[48] If so, the capitalization requirement would apply, and the deduction of swap payments would be limited to the payments received from the other party to the swap unless the hedging exemption applies.

Taxpayers also claim uncertainty in determining whether the hedging exemption applies because of the requirements that the transaction be entered into in the normal course of a trade or business and result only in ordinary income or loss; which requirements implicate the *Corn Products* doctrine. Consider the case of a U.S. corporation that satisfies a need for U.S. dollars by borrowing foreign currency for immediate conversion to U.S. dollars, and then hedges the foreign currency loan (by a currency swap or a forward exchange contract, for example). Assume that the loan proceeds are used for general corporate purposes in the United States. A U.S. corporation might engage in this type of transaction to take advantage of anomalies in foreign capital markets (e.g., the willingness of lenders to accept a lower rate of return on loans of certain currencies). The Committee is informed that some taxpayers take the position that the hedging exemption applies to this situation. Apparently, corporate borrowers rely on the case law that supports ordinary income or loss treatment on repayment of a foreign currency loan; however, it is not clear that such transactions are entered into in the normal course of a trade or business.

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[48] Cf. I.R.C. sec. 1256(e)(2)(A)(ii) (which extends the hedging exemption to borrowings made or obligations incurred; the clear implication is that such transactions would be covered otherwise).

Foreign currency translation

The Committee is about the implicit election enjoyed by CFCs to recognize net exchange losses, and thereby distort the calculation of the deemed-paid foreign tax credit. The Committee is aware of the argument that the electivity achieved by deciding when to trigger subpart F income could be addressed by requiring an irrevocable election to use a profit and loss method or a net worth method. In considering this option, the Committee noted that exchange rate fluctuations with respect to certain currencies are predictable to some extent (e.g., the continuing depreciation of the Brazilian cruzeiro). Thus, a taxpayer would almost always elect the net worth method for operations in a country with a weak currency (to accelerate losses) and the profit and loss method for operations in a country with a strong currency (to defer gain). The Committee was also informed of the argument that a taxpayer could be permitted to choose one translation method for all foreign operations; however, the Committee was not persuaded that this approach would deal with the fundamental objections to the net worth method.

A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes would bear a close relation to taxable income computed by the foreign jurisdiction. In contrast, a net worth method takes unrealized exchange gains and losses into account. Further, a profit and loss method minimizes the accounting procedures that otherwise would be required to make the item-by-item translations under a net worth method. Finally, in the case of a branch, the net worth method as applied under present law fails to characterize accurately items of income or loss that are subject to special U.S. tax rules. For example, although there are limitations on the deductibility of long-term capital losses, such a loss incurred by a branch would be given tax effect because it would be reflected as an adjustment to the balance sheet.

The committee also concluded that the use of a year-end exchange rate distorts income and does not reflect the fact that exchange gain or loss is realized continuously during a taxable year.

Remittances from branches and distributions from subsidiaries

In the case of a branch, because the profit and loss method would not translate balance sheet gains and losses inherent in functional currency or other property remitted to the home office must be provided. A similar issue arises in the case of controlled foreign corporations. Under another provision of the bill, for purposes of the indirect tax credit, the treatment of distributions from controlled foreign corporations as dividends is determined by treating distributions as made from the pool of all of the distributing corporation's earnings and profits. Under the bill, the pooling approach also is used to compute exchange gain or loss on distributions from controlled foreign corporations. One of the reasons for the adoption of the pooling approach is to reverse certain present-law consequences that result in the disparate treatment of branch operations and oper-

ations conducted through a subsidiary. Similarly, for purposes of determining exchange gain on loss or branch remittances, the committee discerned no policy reasons for applying different rules to remittances from a branch and distributions from a subsidiary.

Foreign tax credits

The Committee was persuaded that if exchange gain is not taxed in a foreign jurisdiction, then such amounts should not enable taxpayers to absorb excess foreign tax credits. For this reason, the bill subjects exchange gain or loss on remittances from a branch, or distributions from certain foreign corporations, to a separate limitation for purposes of determining the availability of foreign tax credits.

The committee believes that the *Bon Ami* approach has significant defects: (1) the exchange rate gain or loss between the date income is earned and the date it is paid is, in effect, characterized as an increase or decrease in earnings and profits, and (2) the deemed-paid foreign tax is also increased or decreased by exchange rate fluctuations, even though the tax actually may have been paid in an earlier year (so that the tax liability in terms of U.S. dollars was fixed). There is also a concern about the continued use of a "date of distribution" exchange rate for actual dividends and an "average" exchange rate for subpart F constructive dividends.

The *Bon Ami* approach is often defended on the ground that it preserves the historic ratio between foreign taxes and accumulated profits, so that the U.S. dollar value of the foreign tax eligible for credit is the same percentage of the U.S.-dollar value of the dividend as the effective foreign-currency denominated tax was of the related earnings. On the other hand, it is not clear to the Committee that retention of the foreign tax rate should be a goal of U.S. tax policy. The *Bon Ami* approach results in a tax advantage if the foreign corporation's functional currency appreciates against the dollar, and a tax penalty if the functional currency depreciates in value.

Once a subsidiary actually pays a foreign tax, the U.S.-dollar cost is fixed, and thus if it is desired to obtain similar tax credit results for companies that operate in branch and CFC form, then it is inappropriate to translate the tax liability at an exchange rate in effect at a later date. The *Bon Ami* approach is inconsistent with the rules applied to taxpayers who are eligible for the direct foreign tax credit (because they operate through branches). This inconsistency defeats one of the purposes of the indirect tax credit, which is to equalize the tax burden on domestic corporations operating abroad through subsidiaries and branches. Finally, a corporation operating through a subsidiary always has the option to maintain the desired "historic" relationship between foreign taxes and accumulated profits by repatriating earnings on a current basis. Presumably, this option would be exercised when favorable tax results are anticipated. Thus, the Committee concluded that foreign taxes should be translated at the historical rate, and exchange gain or loss should not be characterized as an increase or decrease in earnings and profits.

1980 Treasury Department Discussion Draft

In December of 1980, the Treasury Department issued a Discussion Draft that set forth a comprehensive proposal for the treatment of exchange gain or loss that arises in a business context (the "1980 Discussion Draft"). The 1980 Discussion Draft adopted an "interest equivalency" approach with respect to assets and liabilities denominated in a foreign currency, under which exchange gain or loss would be treated as an adjustment to interest income or expense, but recognition would be deferred until a transaction was closed out. In addition, a profit and loss method of translation was proposed for all business entities. Finally, on the basis of the Financial Accounting Standards Board exposure draft that became FASB 52, the 1980 Discussion Draft proposed the adoption of the functional currency approach.

Explanation of Provisions

Overview

Under the bill: (1) the tax treatment of an exchange gain or loss turns on the identification of a functional currency, (2) exchange gain or loss is recognized on a transaction-by-transaction basis only in the case of certain transactions (referred to as "section 988 transactions") that are denominated in a currency other than a functional currency, (3) in the case of section 988 transactions, exchange gain or loss is treated generally as an increase or decrease in interest income or expense, and (4) to the extent provided in regulations, exchange gain or loss on certain hedging contracts is characterized and sourced in a manner that is consistent with the related exposure, and a portion of the unrealized exchange gain or loss on section 988 transactions is to be accrued currently.

The bill also provides rules that tend to equalize the tax burden of domestic corporations operating abroad through subsidiaries with that of domestic corporations operating through branches: (1) a single set of criteria is provided for determining the currency in which the results of a foreign operation should be recorded, (2) business entities using a functional currency other than the U.S. dollar are required to use a profit and loss translation method, (3) exchange gain or loss on remittances from a branch, or distributions from 10-percent owned foreign corporations, is treated as separate-basket ordinary income or loss, and (4) a single set of rules applies to the translation of foreign taxes and adjustments thereto.

Functional currency of a business entity

Under the bill, all determinations under the Internal Revenue Code of 1985 (the "Code") are to be made in a taxpayer's functional currency. Except as otherwise provided, a taxpayer's functional currency is the U.S. dollar. In the case of a qualified "business unit" (defined below) the functional currency is the currency used by such unit in keeping its books and records, and in which a significant part of its business activities are conducted. If, however, the activities of a qualified business unit are primarily conducted in U.S. dollars, then the functional currency of such unit is the U.S. dollar.

Qualified business unit

New section 989(a) defines the term "qualified business unit" to mean any separate and clearly identified unit of a taxpayer's active trade or business, if such unit maintains separate books and records in a functional currency. A single taxpayer can have more than one qualified business unit.

The definition of a qualified business unit is intended to be broader in scope than the definition of a "trade or business" within the meaning of section 446(d) (which permits a single taxpayer to use a different method of accounting for each trade or business). Nevertheless, it is intended that each of a taxpayer's qualified business units include every operation that forms a part of the process of earning income (*i.e.*, that the unit could operate at a profit if separated from the rest of the taxpayer's activities). In general, the definition of a qualified business unit will be satisfied on the basis of vertical, functional, or geographic divisions of a single active trade or business, as long as the business unit is capable of producing income independently. For example, assume a corporation that manufactures and sells product X in the United States decides to establish an office in France. The French office maintains one salesperson whose only function is to solicit orders for product X, and the remaining sales functions continue to be conducted in the United States. On these facts, the activity of the French office would not be viewed as giving rise to a qualified business unit of the corporation.

Identification of functional currency

If a business entity does not elect the U.S. dollar as the functional currency, the functional currency generally would be the currency of the country in which the entity is located and the books and records are kept. Thus, most U.S. taxpayers operating in the United States would use the U.S. dollar as the functional currency.

The identification of a functional currency other than the U.S. dollar would be a question of fact. In making this determination, the following factors are to be taken into account: (1) the currency in which the books of account are maintained, (2) the principal currency in which revenues and expenses are generated, (3) the principal currency in which the entity borrows and lends, and (4) the functional currency of related business units, and the extent to which the business unit's operations are integrated with those of the related business units. These factors generally correspond to those applicable under FASB 52.

Although the identification of a functional currency ordinarily requires a factual determination, it is intended that taxpayers use consistent criteria for identifying the functional currency of qualified business units engaged in similar activities in different countries. If the facts and circumstances do not indicate a particular currency (e.g., where an entity conducts significant business in more than one currency), a taxpayer has discretion in choosing a functional currency. The choice of a functional currency, including an election to use the U.S. dollar, is treated as a method of accounting that can be changed only with the consent of the Secretary.

The examples below illustrate the identification of a functional currency on the basis of the above criteria.

Example (7)—A U.S. parent corporation, P, has a wholly owned U.S. subsidiary, S, whose head office is in the United States, although its primary activity is extracting natural gas and oil through a branch in a foreign country. Sales of natural gas and oil are billed in both U.S. dollars and local currency, and significant liabilities and expenses (e.g., loan principal and interest) are denominated in both dollars and local currency. The foreign country requires the branch to keep its books and records in the local currency. In filing federally mandated financial statements P and S elect to use the dollar, not the local currency, as the functional currency of the foreign branch.

In this instance, the branch's books and records are maintained in foreign currency, and a significant part of the branch's activity is conducted in local currency. Under the bill, the branch is a qualified business unit. S's functional currency for tax purposes is the local currency.

Example (8)—A bank incorporated and with its head office in the United States has a branch in a foreign country. Although the foreign country requires the branch to keep books in the local currency, the branch customarily fixes the terms of its loans to local customers by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits (e.g., the interest rate on outstanding loan principal equals LIBOR plus two percent and outstanding loan principal is adjusted to reflect changes in the dollar value of the local currency). Local lending is, in turn, typically funded with dollar-denominated funds borrowed from the head office, other branches and subsidiaries of the same bank, and independent lenders. In turn, the branch lends dollars. The bank elects to use the dollar, not the local currency, as the functional currency of the branch for Federally mandated financial reporting purposes.

In this instance, although the branch maintains its books and records of operation in foreign currency, the branch's activity is conducted primarily in the U.S. dollar. Under the bill, the branch is a qualified business unit and the dollar is the functional currency for tax purposes.

Example (9)—A U.S. taxpayer incorporates a wholly owned subsidiary in Switzerland. All books of record are maintained in Swiss francs, and the Swiss franc is used as the functional currency for financial reporting purposes. The Swiss company is primarily a base company selling the exports of its U.S. parent corporation, and virtually all of its income is foreign base company sales income within the meaning of section 954(d). Most of its transactions are denominated in U.S. dollars or, less frequently, in foreign currencies other than the Swiss franc.

Under the bill, the U.S. dollar is the functional currency of the Swiss company even though its books of record are maintained in Swiss francs and the Swiss franc is the functional currency for financial reporting purposes. This result obtains because the Swiss company's activities are primarily conducted in U.S. dollars.

Election to use U.S. dollar

The bill provides that a qualified business unit can elect to use the U.S. dollar as its functional currency but only if the unit maintains its books and records in the U.S. dollar (i.e., it must use the separate transaction method). The election is effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Secretary. For a U.S. person, the election is to be made on the return for the first taxable year for which a qualified business unit exists, by making a statement that the qualified business unit elects the U.S. dollar as its functional currency for U.S. tax purposes. For a foreign person, the election is to be made in the U.S. owner's return for the first taxable year in which the U.S. owner acquires at least a 10-percent ownership interest in the foreign person by making a statement that the foreign person's qualified business unit elects the U.S. dollar as its functional currency for U.S. tax purposes.

Foreign currency transactions

The bill sets forth rules for the U.S. tax treatment of foreign currency gain or loss attributable to section 988 transactions. Section 988(c) defines the term "section 988 transaction" to mean (1) the acquisition of (or becoming the obligor under) a debt instrument, or accruing (or otherwise taking into account) any item of expense or income that is to be paid or received on a later date, if (2) the amount required to be paid or entitled to be received is denominated in a nonfunctional currency, or is determined by reference to the value of one or more nonfunctional currencies. Foreign currency gain or loss is defined generally as gain or loss realized by reason of a change in the exchange rate between the date an asset or liability is taken into account for tax purposes (i.e., recorded as an item of income or expense, treated as a liability, or assigned an asset basis, referred to as the "booking date") and the date it is paid.

Section 988 transactions

The term section 988 transaction includes the acquisition of any nonfunctional-currency denominated financial asset or liability (including an accrued item of income or expense). For purposes of this rule, a section 988 transaction need not require or even permit repayment with a nonfunctional-currency, as long as the amounts paid or received is determined by reference to the value of a nonfunctional currency. (Thus, the status of multi-currency contracts is clarified.) Examples of section 988 transactions are trade receivables or payables, preferred stock (to the extent provided by regulations), and debt instruments denominated in one or more nonfunctional currencies. The term debt instrument means a bond, debenture, note, certificate, or other evidence or indebtedness.

Special rule for disposition of foreign currency

The disposition of foreign currency is treated as a section 988 transaction. In determining foreign currency gain or loss, the date of acquisition is treated as the booking date, and the date of disposition is treated as the payment date. For purposes of the special

rule for dispositions, the term "foreign currency" includes not only coin and currency, but also foreign-currency denominated demand deposits and similar instruments issued by a bank or other financial institution.

Under the bill, the definition of foreign currency excludes any section 1256 contract that is not part of a hedging transaction (as defined below). In general, section 1256 contracts are defined to include regulated futures contracts covering foreign currency, foreign currency options, and foreign currency forward contracts traded in the interbank market.

Character and source of foreign currency gain or loss

The bill provides that foreign currency gain or loss attributable to a section 988 transaction is treated as ordinary income or loss, (as the case may be), and is recognized notwithstanding any other provision of the Code. Foreign currency gain or loss is generally treated as interest. Foreign currency gain or loss is not treated as interest for purposes of withholding at source, information reporting requirements, or such other purposes as the Secretary may specify in regulations.

Exchange gains are sourced under the same rules that apply to interest income. Exchange losses are allocated and apportioned under the same rules that apply to interest expense.

Hedging transaction

To the extent provided in regulations, if any section 988 transaction is part of a hedging transaction all positions in the hedging transaction are integrated and treated as a single transaction. The committee intends that the regulations pertaining to hedging transactions be narrowly restricted to transactions that are substantially equivalent to U.S.-dollar denominated transactions.

A hedging transaction is defined generally by reference to the definition of a hedging transaction for purposes of the straddle rules (under section 1256(e)(2) of the Code), except the identification requirement of section 1256(e)(2)(C). Thus, as under the straddle rules, a hedging transaction includes certain transactions entered into primarily to reduce the risk of (1) price change or foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) interest rate or price changes, or foreign currency fluctuations with respect to borrowings or obligations of the taxpayer. The bill provides that a hedging transaction is to be identified by the taxpayer or the Secretary.

The committee intends that the regulations relating to hedging transactions provide rules to prevent taxpayers from selectively identifying only those transactions where the hedging rules are favorable to the taxpayer. The committee is aware that rules applicable to partially hedged transactions may be necessary to achieve a hedging rule that is not susceptible to abuse. The committee intends that the regulations require a taxpayer to clearly identify a hedging transaction before the close of the day the transaction is entered into, in order to claim increased deductions attributable to the hedge. The Secretary may identify the transaction as a hedge at a later date. In addition, the regulations will need to take account of the various mechanisms for hedging currency exposure.

For purposes of the special regulatory rules, a hedging position may include any contract (1) to sell or exchange foreign currency at a future date under terms fixed in the contract, (2) to purchase foreign currency with dollars at a future date under terms fixed in the contract, (3) to exchange foreign currency for another foreign currency at a future date under terms fixed in the contract (which would include parallel loans and currency swaps), or (4) to receive or pay dollars or a foreign currency (e.g., interest rate swaps).

The committee is particularly concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing offsetting currency positions. If such a hedging transaction is not treated as an integrated transaction, the taxpayer may be able to defer tax on income (and, under present law, to convert ordinary income to capital gains).

Example (10).—Assume that a taxpayer borrows 1000 units of a weak foreign currency ("F") for 2 years at 30 percent—the market interest rate in this currency. Interest payments are F300 in each of the next 2 years, plus a principal payment of F1000 in 2 years (see Table 1). The high interest rate charged by lenders of this currency, compared to dollar interest rates, reflects the anticipated devaluation of the foreign currency relative to the dollar.

The spot market rate for the foreign currency is F2 per dollar; therefore, the proceeds from the F1000 loan are $500 (F1000 divided by F2/$). Suppose the foreign currency can be purchased 1 year ahead in the forward market at F2.364 per dollar, and 2 years ahead at F2.793 per dollar. Under these facts, the taxpayer can cover its exchange rate exposure on future interest and principal payments by purchasing 1 year ahead F300 for $126.92 (F300 divided by F2.364/$), and 2 years ahead F1300 for $465.38 (F1300 divided by F2.793/$). If the taxpayer fully hedges, then the foreign currency borrowing effectively is converted into a dollar borrowing of $500 with a repayment schedule (interest and principal) of $126.92 next year and $465.38 in 2 years. Under the special rules for hedging transactions, a fully hedged foreign currency borrowing would be treated as the equivalent of a dollar borrowing.

One consequence of treating the hedging transaction described above as a dollar loan is that the deductibility of interest with respect to the loan is governed by the principles of the OID rules (sec. 1271 *et seq.*). Thus, if the hedging rule were applied, the loan would be treated as a dollar-equivalent loan with a 10-percent yield to maturity, rather than a 30-percent yield, as stated in the contract. Under the hedging rule, only $50.00 (10 percent of the $500 loan balance) of the $126.92 paid in the first year (to cover the F300 of foreign currency liability due in that year) would be characterized as interest expense, and the balance ($76.92) would be characterized as principal (see table below). Thus, in the first year, the effect of integrating the hedging transaction is to reduce the allowable interest deduction from $126.92 to $50.00.

FULLY HEDGED FOREIGN CURRENCY LOAN

Year	Foreign Currency Loan			Forward Market		Dollar-Equivalent Loan		
	Balance	Interest	Principal	Forward rate	Cost of Cover	Balance	Interest	Principal
	(F)	(F)	(F)	(F)	($)	($)	($)	($)
0	1000	0	0	2.000	0	500.00	0	0
1	1000	300	0	2.364	126.92	423.08	50.00	76.92
2	0	300	1000	2.793	465.38	0	42.31	423.08
Sum	NA	600	1000	NA	592.30	NA	92.31	500.00

Over the two-year period, the application of the rules for hedging transactions would not change the net amount of deductions ($92.31) arising from the foreign currency loan; instead, the hedging rule would require that interest be characterized and accrued according to OID principles. In the above example, the effect of the hedging rule is to prevent a one-year deferral of tax on $76.92 of income.

Foreign currency translation

An entity that uses a functional currency other than the U.S. dollar is required to use a profit and loss method to translate income or loss into U.S. dollars, at the appropriate exchange rate for a taxable year. Under regulations, in most cases, the appropriate exchange rate is the weighted average exchange rate for a period (i.e., the rate that would produce approximately the same U.S.-dollar amount if each gross receipt were translated on the booking date). The use of an average exchange rate will result in less distortion in measuring income than the use of a year-end rate.

Foreign corporations

For purposes of determining the tax of any shareholder of a foreign corporation, the earnings and profits of the foreign corporation is to be determined in the corporation's functional currency. The bill provides additional rules for domestic corporations that own (directly or indirectly) at least 10 percent of the voting stock of a foreign corporation. In the latter case, exchange gain or loss with respect to distributed earnings is treated as ordinary income or loss, subject to a separate limitation for purposes of the overall limitation on the foreign tax credit. These rules apply to actual distributions, deemed distributions of subpart F income, and gain that is recharacterized as dividend income on the disposition of stock in a CFC (or former CFC).

Translation of earnings and profits

On the distribution of earnings and profits from a 10-percent owned foreign corporation, a domestic corporation is required to translate such amounts at the appropriate exchange rates for the years in which earned. Exchange gain or loss on distributions sub-

ject to this rule is calculated by computing the difference between (1) the amount of the distribution that constitutes a dividend, determined in the foreign currency, translated at the appropriate exchange rates, and (2) the value of the distribution translated at the exchange rate for the year of distribution. Exchange gain or loss with respect to distributions of earnings and profits is characterized as ordinary income or loss (as the case may be). Further, such income or loss is subject to a separate limitation for purposes of the overall limitation on the foreign tax credit. In applying the provisions for separate-basket treatment, the look-through rules of section 904(d)(3) and (4) (added by section 601 of the bill) apply.

Treatment of foreign taxes

For purpose of determining the amount of foreign taxes deemed paid under sections 902 or 960: (1) a foreign income tax paid by a foreign corporation is translated into U.S. dollars using the exchange rate in effect as of the date of payment (and the U.S.-dollar amount of the translated tax is "grossed-up" under section 78); (2) any refund of a foreign tax is translated into U.S. dollars using the exchange rate in effect as of the time of payment of the tax, and (3) any other adjustment to a foreign tax (e.g., an increase in the amount) is translated at the exchange rate in effect on the date of adjustment.

Under the bill, a prepayment of a foreign tax (e.g., payments of estimated taxes or withheld taxes) is to be translated at the rate in effect on the date of payment, and any adjustment thereto is to be translated at the appropriate exchange rate for the date of the adjustment. Installment payments of tax are to be translated at the exchange rate in effect on the date of each installment payment. If a tax is paid by way of crediting an overpayment from one year against another year's liability, the transaction is treated as (1) an adjustment of the tax for the first year, and (2) a payment of the tax for the second year.

Example (11).—Assume that a domestic corporation organizes a CFC in year one. Assume that the CFC's functional currency is the "K." The results of the CFC's operations are as shown in the table, below.

	Income	Foreign taxes	Exchange rate
Year 1	100K/$50	23K/$11.50	2K:$1
Year 2	100K/$80	23K/$18.40	1.25K:$1
Year 3	100K/$100	23K/$$23	1K:$1

Assume that the CFC distributes its after-tax earnings at the end of year three. Under the bill, the following results would obtain:

(1) Distribution--The amount of the earnings and profits distributed is $177.10 (231K translated at the appropriate exchange rates for the years in which earned):

a. 77K at 2K:$1=$38.50 ($38.50 gain)
b. 77K at 1.25K:$1=$61.60 ($15.40 gain)
c. 77K at 1K:$1=$77.00 (no gain or loss).

(2) Section 78 gross-up -$52.90 (sum of foreign taxes paid translated at historical rates) + $177.10=$230.

(3) 902 fraction -$52.90 (sum of foreign taxes translated at historical rates) x 231K (dividend denominated in the foreign currency)/231K (pool of earnings denominated in the foreign currency)=$52.90.

(4) Separate basket exchange gain or loss—the $38.50 gain plus the $15.40 gain, as calculated above in step (1). The $53.90 ($38.50 + $15.40) exchange gain is taxable to the U.S. shareholder with no offsetting foreign taxes. The tentative U.S. tax is (at the maximum 36-percent corporate rate under the bill) is $102.20. (on total income of $230 + $53.90), offsetting indirect FTC is $52.90, and net U.S. tax is $49.30.[49]

Translation of branch income and losses

Under the bill, taxpayers with branches whose functional currency is a currency other than the U.S. dollar will be required to use the profit and loss method to compute branch income.[49a] Thus, the net worth method will no longer be an acceptable method of computing income or loss of a foreign branch for tax purposes, and only realized exchange gains and losses on branch capital will be reflected in taxable income.

For each taxable year, the taxpayer will compute income or loss separately for each qualified business unit in the business unit's functional currency, converting this amount to U.S. dollars at the appropriate exchange rate. This amount will be included in income without reduction for remittances from the branch during the year.

The appropriate exchange rate is to be determined under regulations issued by the Treasury Department. In general, the appropriate exchange rate will be the weighted average exchange rate for the taxable period over which the income or loss accrued (consistent with the rules applicable to foreign corporations). The committee anticipates that the regulations under this provision will provide rules that will limit the deduction of branch losses to the taxpayer's dollar basis in the branch (that is, the original dollar investment plus subsequent capital contributions and unremitted earnings).

A taxpayer will recognize exchange gain or loss on remittances of branch profits (whether or not actually converted to dollars) to the extent the value of the currency in the year of the remittance differs from the value when earned. Consistent with the treatment of distributions from foreign subsidiaries, the bill provides that remittances of foreign branch earnings (and interbranch transfers in-

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[49] If only half of the 231K of earnings and profits (i.e., 115.5K) were distributed in year 3, then the deemed-paid tax would have been $26,45 (half of $52.90), the grossed-up dividend would have been $115 (half of $230), and the separate basket exchange gain would have been $26.95 (half of $53.90).

[49a] These translation rules will apply regardless of the form of enterprise (e.g., sole proprietorship, partnership, or corporation) through which the taxpayer conducts its business, provided at least one qualified business unit of the taxpayer uses a functional currency currency other than the dollar. For convenience, however, this discussion assumes the taxpayer is a corporation operating through a foreign branch.

volving branches with different functional currencies) after 1985 will be treated as paid pro rata out of post-1985 accumulated earnings of the branch. The committee anticipates that, in general, the value of the currency will be determined by translating the currency at an average exchange rate for the year in which received rather than the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary, and subject to separate limitations.

The bill provides that the translation of payments of, and subsequent adjustments to, foreign taxes by a branch will be performed under the same rules that apply in determining the foreign tax credit allowable to a parent corporation with respect to taxes paid by a foreign subsidiary. For example, assume a branch pays a tax of 100 Swiss francs in year one. In year two, the branch's tax liability is 50 francs, and the year one tax is adjusted downwards to 60 francs (so there was an overpayment of 40 francs). The 40-franc overpayment from year one is applied against the 50-franc liability for year two. In year three, the 50-franc tax paid in year two is refunded. On these facts, (1) regarding the reduction in the tax paid in year one, the 40 francs are translated at the exchange rate used to translate the tax in year one, and exchange gain or loss (as the case may be) is realized if there is any difference between that exchange rate and the appropriate exchange rate for year two, (2) regarding the crediting of the 40-franc overpayment against the 50-franc tax liability for year two, the entire 50-franc tax is translated at the rate in effect on the date the taxpayer is treated as having paid such tax, and (3) on refund of the year-two 50-franc tax in year three, the refund is translated at the same rate that was used to translate the tax payment in year two, and exchange gain or loss (as the case may be) is realized if there is any difference between that exchange rate and the appropriate exchange rate for year three.

Example.—Assume that a domestic corporation organizes a foreign branch in year one. Assume further that the branch is a qualified business unit, and the branch's functional currency is K. For years 1-3, the branch's income, the foreign taxes paid, and the relevant exchange rates are the same as those in the example involving the organization of a CFC, above. The results of the branch's operations are as follows:

Year one.—Taxpayer has $50 of income, subject to tentative U.S. Tax of $18 (calculated at the 36-percent maximum corporate tax rate under the bill), and an offsetting FTC of $11.50. Net U.S. tax is $6.50.

Year two.—Taxpayer has $80 of income, subject to tentative U.S. tax of $28.80, and an offsetting FTC of $18.40. Net U.S. tax is $10.40.

Year three.—Taxpayer has $100 of income, subject to tentative U.S. tax of $36, and an offsetting FTC of $23. Net U.S. tax is $13.

Remittance of after-tax earnings in year three.—Under the bill, the remittance of 231K would trigger $53.90 of separate-basket exchange gain (attributable to the difference between the current exchange rate and the rates in effect for the years in which earned), with no offsetting foreign taxes:

1. 77K at 2K:$1 =$38.50 (difference of $38.50)

2. 77K at 1.25K$1: =$61.60 (difference of $15.40)
3. 77K at 1K:$1 =$77 (no difference).

Cumumlatively, tentative U.S. tax liability is $102.20 (on total income of $230 plus $53.90), the offsetting FTC is $52.90, and the net U.S. tax is $49.30. The results in this example are identical to those in the example involving a CFC, above. In other cases, timing differences in the tax treatment of branches and subsidiaries may arise where taxpayers have excess credits or are in an overall foreign loss position.

Other issues

In general, the Secretary is authorized to issue such regulations as may be necessary to carry out the purposes of the new rules for foreign currency transactions. It is intended that the Secretary issue regulations providing, *inter alia*, (1) subject to an identification requirement, for taxpayers to elect to accrue exchange gains and losses on working balances of foreign currency held for use in a trade or business, and (2) for the treatment of U.S. branches of foreign persons (addressing issues such as the extent to which exchange gain or loss on remittances are treated as effectively connected with a U.S. trade or business).

Effective Date

The bill is effective for taxable years beginning after December 31, 1985.

Revenue Effects

The provision for the taxation of foreign currency gain or loss is estimated to increase fiscal year budget receipts by $18 million in 1986, $29 million in 1987, $29 million in 1988, $32 million in 1989, and $36 million in 1990.

G. Tax Treatment of Possessions (Secs. 645 and 671-677 of the bill and secs. 32, 48, 63, 153, 246, 338, 864, 876, 881, 882, 931-936, 934A, 957, 1402, 1442, 6091, 7651, 7654, and 7655 of the Code)

Present Law

Overview

The income tax laws of the United States are in effect in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their local income tax systems. These jurisdictions are termed "possessions" of the United States for tax purposes. To transform the Internal Revenue Code of 1954, as amended ("the Code"), into a local tax code, each possession, in effect, substitutes its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. Although this word-substitution system, known as the "mirror system", applies to Guam, the CNMI, the Virgin Islands, and American Samoa, the U.S. tax relationship with each possession is governed by somewhat different rules, as described below.

Guam

Under the Organic Act of 1950, Guam currently employs the mirror system of taxation. Under Code section 935, an individual resident of the United States or Guam is required to file, with respect to income tax liability to those jurisdictions, only one tax return—with Guam if the taxpayer is a Guamanian resident on the last day of the taxable year, or with the United States if the taxpayer is a U.S. resident on the last day of the year (the "single filing rule"). Withheld and estimated income taxes paid to the jurisdiction in which a return is not filed may be claimed as a credit against tax imposed by the jurisdiction of filing. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals (but not corporations), the United States is treated as part of Guam for purposes of Guamanian taxation, and Guam is treated as part of the United States for purposes of U.S. taxation.

A corporation chartered in Guam that receives U.S. source income (other than certain passive income) must file a U.S. return and pay U.S. tax on that income. Under Code section 881(b), a Guamanian corporation is not treated as a foreign corporation for purposes of the 30-percent withholding tax on certain passive income paid to foreign corporations if (1) less than 25 percent in value of its stock is owned by foreign persons, and (2) at least 20 percent of its gross income is derived from sources within Guam.

Under U.S. law, Guam is authorized to impose up to a 10-percent surtax on income tax collected under the mirror system and may provide for rebates of mirror system taxes in certain circumstances.

Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, applies to Guam. In effect, a section 936 corporation operating in a possession such as Guam enjoys an exemption from all U.S. tax on the income from its business activities and qualified investments in that possession. To qualify for this treatment, the section 936 corporation must meet two conditions: (1) at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within the possession; and (2) at least 65 percent of its gross income for that period must be from the active conduct of a trade or business in that possession.

Federal statutes do not permit Federal employers to withhold territorial income taxes. However, under Code section 7654, the United States generally covers over (i.e., transfers) to the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on Federal personnel employed or stationed in Guam. Similarly, Guam covers into the treasury of the United States certain tax collected from individuals on U.S. source income.

Banks organized in Guam are subject to tax on interest on U.S. Government obligations on a net basis.

CNMI

As of January 1, 1985, the CNMI is required to implement the mirror system in substantially the same manner as the mirror system is in effect in Guam. Code references to Guam are deemed to include the CNMI. Thus, the single filing rule for individuals under Code section 935 and the special withholding tax rule for interest and other passive income earned by corporations under section 881(b) also apply to the CNMI. In addition, U.S. law provides that the CNMI by local law may impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.

Virgin Islands

Under the Naval Appropriations Act of 1922, the income tax laws of the United States, as amended, are held to be "likewise in force in the Virgin Islands", except that the proceeds of the income tax are paid into the treasury of the Virgin Islands. The courts have interpreted this provision to establish a mirror system of taxation in the Virgin Islands.

Under section 28(a) of the Revised Organic Act of the Virgin Islands, as interpreted by the courts, an "inhabitant" of the Virgin Islands is exempt from U.S. tax as long as the inhabitant pays tax to the Virgin Islands on its worldwide income. The term "inhabitant", for these purposes, has generally been interpreted to include individual residents of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and corporations not organized under the laws of the Virgin Islands if such corporations

have contacts with the Virgin Islands sufficient to establish "residence" in the Virgin Islands.

Notwithstanding section 28(a) of the Revised Organic Act, Virgin Islands corporations, which are generally treated as foreign corporations, are liable for the U.S. 30-percent withholding tax on certain payments to foreign corporations. Under Code section 881(b), however, a Virgin Islands corporation is not treated as a foreign corporation for purposes of this tax if (1) less than 25 percent in value of its stock is owned by foreign persons, and (2) at least 20 percent of its income is derived from sources within the Virgin Islands.

Under Code section 934, the Virgin Islands generally is prohibited from reducing or rebating taxes imposed under the mirror system, with the following exceptions: (1) the prohibition does not apply (with respect to taxes on certain income derived from Virgin Islands sources) in the case of a full-year Virgin Islands resident individual; and (2) the prohibition does not apply (with respect to taxes on non-U.S. source income) in the case of a Virgin Islands or U.S. corporation which derives at least 80 percent of its income from Virgin Islands sources and at least 65 percent of its income from a Virgin Islands trade or business. Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, does not apply to investment in the Virgin Islands. Code section 934(b), in conjunction with section 28(a) of the Revised Organic Act, however, provides similar results. Under Code section 934A, the 30-percent withholding tax on certain payments to foreign persons (including U.S. persons), as imposed under the Virgin Islands mirror system, applies to payments to U.S. persons at a reduced 10-percent rate (which may be further reduced by the Virgin Islands).

The Virgin Islands is authorized to impose up to a 10-percent surtax on the mirror system tax. Otherwise, the Virgin Islands does not have the power to impose local taxes on income.

American Samoa

Unlike the possessions described above, U.S. law permits American Samoa to assume autonomy over its own income tax system. In 1963, however, American Samoa adopted the U.S. Internal Revenue Code as its local income tax. While American Samoa has the power to modify the Code for purposes of American Samoa's territorial tax, this authority has been exercised on only a few occasions, generally to adapt the Code to the needs of American Samoa.

Under section 931, U.S. citizens who receive 80 percent or more of their gross income from sources within American Samoa and 50 percent or more of their gross income from the conduct of a trade or business in American Samoa are exempt from U.S. tax on income derived from sources without the United States. In addition, Code section 936 applies to qualifying U.S. corporations doing business in American Samoa.

Reasons for Change

The Internal Revenue Code, with all its complexities, is designed primarily to tax income in the highly developed U.S. economy. The

mirror system, which entails imposing the Code in its entirety as local law, may be wholly inappropriate for the island economies of the U.S. possessions. The possessions need tax systems that help them to pursue development policies and to exercise greater control over their own economic welfare.

The frequency and extent of revisions to the Code in recent years have highlighted the problems inherent in the mirror systems. For example, in the possessions, a large portion of the revenue is collected from individuals in the lower tax brackets. Typically, the portion of local revenues collected from corporations and higher-income individuals is very small. Thus, revisions to the Code that lower the tax rates on individuals (such as the rate reductions enacted by the Economic Recovery Tax Act of 1981 and those contained in this bill) could have a substantial adverse effect on the possessions. In addition, revenue-neutral proposals that compensate for lowering tax rates by broadening the tax base may well not be revenue neutral in a possession where relatively little tax is collected from corporations or higher-income individuals.

The present mirror systems are very complex and the possessions often lack the resources to enforce these mirror systems effectively. Because of the difficulties of enforcement and the ambiguities and inconsistencies inherent in the mirror system, U.S. taxpayers may seek to abuse the mirror systems.

Therefore, to promote fiscal autonomy of the possessions, it is important to permit each possession to develop a tax system that is suited to its own revenue needs and administrative resources. It is also important to coordinate the possessions' tax systems with the U.S. tax system to provide certainty and minimize the potential for abuse.

The deficiencies in the current mirror systems of taxation afflict each possession, though in differing respects. The close economic relationship between Guam and the CNMI has given rise to mirror system problems resulting, in some cases, in harsh consequences for residents of Guam. With respect to the CNMI, the mirror system of taxation went into full force for the first time in 1985. The CNMI has repeatedly voiced its concern that it lacks the resources to administer and enforce the complex mirror system. In addition, American Samoa has had difficulty collecting tax from U.S. Government employees because the United States lacks authority to withhold American Samoan tax from wages.

With respect to the Virgin Islands, the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gives rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties make administration of the law problematic, creating a climate of uncertainty for investors, and raising the possibility of unintended tax benefits for some and harsh consequences for others. In particular, application of the ambiguous "inhabitant" rule of the Revised Organic Act has fostered tax avoidance and tax evasion schemes.

While the committee believes it is appropriate to provide more local autonomy to these possessions, the committee does not intend to allow them to be used as tax havens. The committee believes that it may be appropriate for these possessions to reduce tax on local income in some cases, but the committee has included anti-

abuse rules to prevent use of these possessions to avoid U.S. tax. The complexity and ambiguity of the present law rules have provoked taxpayers to take return positions that, while plausible under a literal reading, would result in tax avoidance beyond what taxpayers would ask from this committee or from Congress. The committee is seeking to prevent this in the future.

Explanation of Provision

Overview

The provision eliminates the requirement that there be a mirror system of taxation in Guam and the CNMI, coordinates the tax systems of those possessions and of American Samoa with the U.S. tax system, and reforms the mirror system in the Virgin Islands. The treatment of the Virgin Islands reflects extended discussions between representatives of the Virgin Islands and the Treasury. It differs from the treatment of the other possessions because of the unique history of the relationship between the Virgin Islands and the United States.

Guam, the CNMI, and American Samoa

Guam, the CNMI, and American Samoa generally are granted full authority over their own local income tax systems, with respect to income from sources within, or effectively connected with the conduct of a trade or business within, any of these three possessions and with respect to any income received or accrued by any resident of any of these three possessions. This grant of authority is effective, however, only if and so long as an implementing agreement is in effect between the possession at issue and the United States which provides for (1) eliminating double taxation of income by the possession and the United States; (2) establishing rules for the prevention of evasion or avoidance of U.S. tax; (3) the nondiscriminatory treatment by the possession of citizens and residents of the United States and the other possessions; (4) the exchange of information between the possession and the United States for purposes of tax administration; and (5) resolving other problems arising in connection with the administration of the tax laws of such possession and the United States. Thus, as is currently the case with respect to American Samoa, each of these possessions could adopt a mirror system as its local law if desired.

An individual who is a bona fide resident of Guam, American Samoa, or the CNMI during the entire taxable year is subject to U.S. taxation in the same manner as a U.S. resident. However, in the case of such an individual, gross income for U.S. tax purposes does not include income derived from sources within any of the three possessions, or income effectively connected with the conduct of a trade or business by that individual within any of the three possessions. Deductions (other than personal exemptions) properly allocated and apportioned to such excluded income will not be allowed for U.S. tax purposes. Thus, even a bona fide resident of Guam, the CNMI, or American Samoa is required to file a U.S. return and to pay taxes on a net basis if he receives income from sources outside the three possessions (i.e., U.S. or foreign source income). However, a U.S. return is not required to be filed if the

possession resident's non-possession source income is less than the amount that gives rise to a filing requirement under generally applicable U.S. rules. The United States will cover over to the Treasuries of Guam, American Samoa, or the CNMI all U.S. income tax paid by a bona fide Guamanian, Samoan, or CNMI resident.

Amounts paid to a bona fide resident of Guam, the CNMI or American Samoa for any services as an employee of the United States (including pensions, annuities, and other deferred amounts received on account of such services) are not treated as possessions source income, so they are fully taxable by the United States. The U.S. tax withheld on these amounts is to be covered over to the treasury of the possession where the recipient resides, thus providing the possession with the revenue it currently receives.

The bill delegates to the Secretary of the Treasury the authority to prescribe regulations to determine whether income is sourced in, or effectively connected with the conduct of a trade or business in, one of these possessions, and to determine whether an individual is a resident of one of these possessions. The committee anticipates that the Secretary will use this authority to prevent abuse. For example, the committee does not believe that a mainland resident who moves to a possession while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the possession should escape all tax, both in the United States and the possession, on that appreciation. Similarly, the committee does not believe that a resident of a possession who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the possession should escape tax on the ordinary income from those assets. The Secretary should treat such income as sourced outside the possession where the taxpayer resides. Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of a possession.

Code section 881(b) is modified to provide that a Guamanian, CNMI, or American Samoan corporation will not be exempt from the 30-percent withholding tax unless (a) less than 25 percent in value of the corporation's stock is owned by foreign persons; (b) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States; and (c) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of these three possessions, the Virgin Islands, or the United States. This exception from withholding also applies with respect to corporations organized in the U.S. Virgin Islands.

The bill also provides rules which relieve a bona fide resident of Guam, the CNMI or American Samoa from being considered a U.S. person for purposes of applying certain reporting and taxation rules under subpart F with respect to corporations incorporated in Guam, the CNMI, or American Samoa (a) at least 80 percent or more of whose income for a preceding three-year period is from sources in, or effectively connected with the conduct of a trade or business in, the possession, and (b) at least 50 percent of the gross income of the corporation for such period was derived from the conduct of an active trade or business in such possession.

As a condition for the grant of full authority over their local income tax systems, Guam, the CNMI, and American Samoa are required to enter into agreements prohibiting discriminatory treatment of citizens and residents of the United States. These possessions also will be required to exchange tax information with the United States under a mutually agreed upon procedure. Local taxes of Guam, the CNMI, and American Samoa will be creditable for U.S. tax purposes if such taxes qualify as creditable taxes under the applicable foreign tax credit regulations. Withholding on the compensation of U.S. Government personnel, including military personnel, stationed or resident in Guam, the CNMI, and American Samoa, will be covered over to the Treasuries of Guam, the CNMI, and American Samoa, as appropriate.

The committee expects and intends that the fiscal actions taken by Guam, the CNMI and America Samoa, respectively, under the provisions of this bill will not result in any substantial reduction in aggregate revenues collected by the possession. The committee has not included a provision in the bill to compare revenues collected under the bill with revenues that would have been collected under present law had the bill's provisions not come into effect. Such a comparison would entail calculation of hypothetical tax liability for the entire economy of an insular area. Nonetheless, the committee expects and intends that each insular area (possession) that the bill affects will collect annual revenues equal to the revenues collected under current law, adjusted for inflation.

The bill repeals the rule that subjects Guamanian banks to net basis taxation of interest on U.S. Government obligations. Thus, any Guamanian bank will be exempt from U.S. tax on this income, unless it becomes subject to the anti-conduit rules that apply to Guamanian corporations.

Virgin Islands

Changes relating to all taxpayers

The bill provides that the Revised Organic Act is treated as if it were enacted before the Code, so that in cases of conflict, the Code controls. The bill specifies that the Revised Organic Act will have no effect on any person's tax liability to the United States. Thus, for example, even if a person is treated as an "inhabitant" of the Virgin Islands under the Revised Organic Act, that person will be fully subject to U.S. tax. Second, the Secretary of the Treasury is given authority to provide by regulation the extent to which provisions in the Internal Revenue Code shall not apply for purposes of determining tax liability to the Virgin Islands (i.e., shall not be mirrored). It is anticipated that such regulations will provide that references to possessions of the United States will not be mirrored. In addition, the committee anticipates that these regulations will prevent abuses of the V.I. and U.S. tax systems such as that addressed by section 130 of the Tax Reform Act of 1984 (preventing tax-free payments of U.S. source income to foreign investors which arguably had been possible due to the interaction of the Revised Organic Act and the "mirror Code"). Third, the Virgin Islands is provided with authority to enact nondiscriminatory local income taxes (which for U.S. tax purposes would be treated as State or

local income taxes) in addition to those imposed under the mirror system. Fourth, the authority of the Virgin Islands to reduce or rebate Virgin Islands tax liability is extended to apply to any V.I. tax liability attributable to income from Virgin Islands sources or to income which is effectively connected with the conduct of a trade or business in the Virgin Islands, in the case of all U.S. and Virgin Islands corporations (without regard to whether specified percentages of their income are derived from the Virgin Islands) and all foreign persons. However, this modification is conditioned upon the existence of an agreement between the United States and the Virgin Islands containing safeguards against the evasion or avoidance of United States income tax. The committee anticipates that such an agreement will contain measures coordinating the tax administration functions of the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue, as well as procedures for exchanging tax information. This modification of the Virgin Islands' authority to reduce taxes applies only to V.I. source income, or income effectively connected with the conduct of a V.I. trade or business, as those terms are defined under regulations prescribed by the Secretary.

The committee anticipates that the Secretary will use this authority to prevent abuse. For example, the committee does not believe that a mainland resident who moves to the Virgin Islands while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the Virgin Islands should escape all tax, both in the United States and the Virgin Islands, on that appreciation. Similarly, the committee does not believe that a resident of the Virgin Islands who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the Virgin Islands should escape tax on the ordinary income from those assets. The Secretary should treat such income as sourced outside the Virgin Islands. Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of the Virgin Islands.

Changes relating only to individuals

Under the bill, for purposes of determining the tax liability of individuals who are citizens or residents of the United States or the U.S. Virgin Islands, the United States will be treated as including the Virgin Islands (for purposes of determining U.S. tax liability), and, under the Virgin Islands "mirror" Code, the Virgin Islands will be treated as including the United States (for purposes of determining liability for the Virgin Islands tax). A corporation organized in one jurisdiction, however, will continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year will pay tax to the Virgin Islands under the mirror system on his or her worldwide income. He or she will have no final tax liability for such year to the United States, as long as he or she identifies the source of each item of income on the return. Any taxes withheld and deposited in the United States from payments to such an individual, and any esti-

mated tax payments properly made by such an individual to the United States, will be covered over to the Virgin Islands Treasury, and will be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands will list all items of such income on an attachment to his or her Virgin Islands return. Information contained on these attachments will be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

A citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands will not be liable to the Virgin Islands for any tax determined under the Virgin Islands "mirror Code". Rather, in the case of such a person, tax liability to the Virgin Islands will be a fraction of the individual's U.S. tax liability, based on the ratio of adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income. Such an individual will file identical returns with the United States and the Virgin Islands. The Virgin Islands' portion of the individual's tax liability (if paid) will be credited against his total U.S. tax liability. Taxes paid to the Virgin Islands by the individual, other than the Virgin Islands portion of his U.S. tax liability, will be treated for U.S. tax purposes in the same manner as State and local taxes.

In the case of a joint return where only one spouse qualifies as a resident of the Virgin Islands, resident status of both spouses will be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year.

Changes relating only to corporations

As noted above, the bill amends the exemption from the 30 percent withholding tax that applies under section 881(b) to possessions corporations, including Virgin Islands corporations. Under the bill, a Virgin Islands corporation will be exempt from withholding only if (a) less than 25 percent in value of the corporation's stock is owned by foreign persons; (b) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States, and (c) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of the possessions or the United States. Thus, the exemption from the withholding tax will not be available for a corporation used as a conduit for payments to persons not resident in the Virgin Islands, the United States, or the other possessions. The bill provides that corporations operating in the Virgin Islands are eligible for the possession tax credit allowed under section 936.

Effective Dates

Guam, the CNMI, and American Samoa

The grants of authority to Guam and the CNMI, as well as the conforming changes to U.S. law, anti-abuse provisions, and administrative provisions, will be effective for taxable years beginning on or after the later of January 1, 1986 or the date an implementing

agreement between the United States and the possession is in effect. The mirror codes currently administered by Guam and the CNMI will continue to operate, *mutatis mutandis*, as their respective local income tax laws, until and except to the extent that each possession takes action to amend its tax laws. The anti-abuse and administrative provisions with respect to American Samoa also are effective for taxable years beginning on or after the later of January 1, 1986 or the date an implementing agreement between the United States and the possession is in effect. The amendment to the rule taxing Guamanian banks on a net basis on income from U.S. Government obligations is effective for taxable years beginning after November 16, 1985.

Virgin Islands

The Virgin Islands provisions are generally effective for taxable years beginning on or after January 1, 1986. However, the provisions extending the right of the Virgin Islands to reduce the tax imposed on income from V.I. sources or income effectively connected with a V.I. trade or business will become effective only when an agreement between the United States and the Virgin Islands to cooperate on tax matters becomes effective.

Revenue Effect

The provisions are estimated not to have a significant effect on fiscal year budget receipts in the 1986-1990 period.

TITLE VII—TAX-EXEMPT BONDS

A. Tax-Exempt Bond Provisions (secs. 701 and 703 of the bill; secs. 25, 103, and 103A and new secs. 141-150 of the Code)

Present Law

Overview

Interest on obligations issued by States, territories, and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103).[1] Similarly, interest on obligations of political subdivisions of these governmental entities generally is tax-exempt.[2]

In determining whether interest on a particular obligation of a qualified governmental unit is tax-exempt, a three-part inquiry is made. First, the activity being financed, and thereby the type of bond being issued, must be determined. (The type of bond generally is determined by the use of the bond proceeds.) Second, the authority of the issuer to issue the tax-exempt debt must be established. Finally, compliance with Internal Revenue Code rules governing tax-exempt bonds for the activity being financed must be established.

Under these rules, qualified governmental units may finance governmental projects or services, including facilities such as schools, roads, and water and sewer facilities. Additionally, governmental units may provide tax-exempt financing for use by charitable, religious, scientific, or educational organizations (section 501(c)(3) organizations) and for certain activities of nongovernmental persons (by means of certain industrial development bonds (IDBs), student loan bonds, and mortgage subsidy bonds). Interest on financings for activities of nongovernmental persons (other than the activities of section 501(c)(3) organizations) is taxable unless an exception is provided in the Internal Revenue Code for the specific type of financing.

Bonds for governmental activities

Obligations to finance government operations

Qualified governmental units may issue tax-exempt bonds to finance general government operations and services, such as schools, courthouses, roads, and governmentally owned and operated water, sewer, and electric facilities, without regard to most of the restric-

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[1] In certain cases, these bonds may be issued on behalf of States or local governments. (*See*, e.g., Rev. Rul. 63-20, 1963-2 C.B. 397 and Rev. Proc. 92-26, 1982-1 C.B. 476. References to bonds issued by States or local governments herein generally include such bonds issued on behalf of those governmental units under the rules established in these Treasury Department rules.

[2] Governments of States, U.S. possessions and the District of Columbia, and their political subdivisions, are hereinafter referred to collectively as qualified governmental units.

tions (including volume limitations) that apply to bonds used to finance activities of nongovernmental persons (other than section 501(c)(3) organizations).[3] Under these rules, for example, qualified governmental units may issue notes in anticipation of tax or other revenues (so-called tax anticipation or revenue anticipation notes (TANs or RANs)).

In addition to issuing bonds as evidence of indebtedness, qualified governmental units may undertake debt, the interest on which is tax-exempt, by means of installment sales contracts or finance leases. For example, a qualified governmental unit may purchase road construction equipment pursuant to a lease purchase agreement or an ordinary written agreement of purchase and sale. Interest paid on such acquisitions is tax-exempt if the amounts are true interest (as opposed to other payments labeled as interest). *See*, e.g., sec. 1273, Rev. Rul. 60-179, 1960-1 C.B. 37, and Rev. Rul. 72-399, 1972-2 C.B. 73. These other types of financings must satisfy the same Code requirements as if a bond actually were issued. Interest paid by qualified governmental units other than pursuant to exercise of their borrowing power (e.g., interest on tax refunds) is not tax-exempt.

Present law does not contain a direct definition of when bond proceeds are used for governmental activities. Rather, bonds are treated as governmental and the interest thereon is tax-exempt unless a prescribed amount of the bond proceeds is used for activities of nonexempt persons (i.e., persons other than qualified governmental units or section 501(c)(3) organizations).[4]

Use in certain trades or businesses

The first case in which bonds issued by qualified governmental units are treated as nongovernmental (causing the interest thereon to be taxable) is when the bonds are IDBs. IDBs are obligations issued as part of an issue (1) all or a major portion of the proceeds[5] of which is to be used (directly or indirectly) in a trade or business carried on by a nonexempt person and (2) the payment of a major portion of the principal of, or interest on, which is derived from, or secured by, money or property used in a trade or business (sec. 103(b)). Interest on IDBs is taxable unless the bonds are issued to finance certain specified exempt activities, are used for development of industrial parks sites, or are exempt small issues.

Use to make certain loans

The second case in which obligations of qualified governmental units are treated as nongovernmental is when the bonds violate a private loan bond restriction.[6] Private loan bonds are obligations that are part of an issue five percent or more of the proceeds of which is reasonably expected to be used, directly or indirectly, to

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[3] In general, present law treats bonds for the benefit of section 501(c)(3) organizations in the same manner as bonds used to finance general government operations.

[4] The United States (including its agencies and instrumentalities) and all persons other than States or local governments (except organizations described in sec. 501(c)(3)) are nonexempt persons under these rules.

[5] Regulations define a major portion as 25 percent or more of the bond proceeds.

[6] The term private loan bond is substituted for the present-law term "consumer loan bond" by Title XIV of the bill, relating to technical corrections to the Deficit Reduction Act of 1984 (the 1984 Act).

make or finance loans to persons other than exempt persons. Present law includes exceptions to the private loan bond restriction for activities of nonexempt persons with respect to which Congress has provided specifically in the Code that tax-exempt financing is to be available. Thus, exceptions are provided for IDBs, qualified student loan bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds.[7]

Additionally, an exception is provided for loans to nonexempt persons to finance taxes or assessments of general application (tax-assessment bonds). Under this exception, the loans to nonexempt persons are disregarded in determining whether interest on bonds is tax-exempt. Rather, the determination of whether such interest is tax-exempt is made by disregarding the loans and determining whether any other use of the bonds qualifies the interest on the bonds for tax-exemption. For example, the fact that a qualified governmental unit permits residents generally to pay mandatory assessments levied in connection with sewer, water, or similar specific governmental projects over a period of years generally is disregarded in determining whether interest on bonds for water or sewer facilities is tax-exempt. That determination is made by reference to the use of the bond-financed property. For example, if a water or sewer system is operated in a manner that causes the bonds to satisfy the trade or business use and security interest tests of the Code, the bonds are IDBs.

The private loan bond restriction applies whether bonds are used to finance loans for businesses or to finance personal loans. For example, an issue may be an issue of taxable private loan bonds if five percent or more, but no more than 25 percent, of the proceeds are used to make loans that would be considered IDB financing, except for the fact that bonds are not treated as IDBs if no more than 25 percent of the proceeds is used to finance an activity satisfying the trade or business use test of the Code (sec. 103(b)(2)(A)). Similarly, a bond may violate this restriction in cases where the bond is not an IDB because the security interest test is not violated (sec. 103(b)(2)(B)).

The concepts of use and loan

Concept of use

The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for an activity of a nongovernmental person. Under present law, the principal application of the use concept is the determination of whether a bond is an IDB. Additionally, the satisfaction of numerous requirements for specific types of tax-exempt IDBs is determined by applying the use concept.

The ultimate beneficiary of the tax-exempt bond financed property generally is treated as the user of the bond proceeds and of bond-financed property. A person may be a user of bond proceeds

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[7] Certain private loan bond programs in existence when this restriction was enacted also are not subject to the requirement. *See*, sec. 626(b) of the 1984 Act. These include certain supplemental student loan bond programs and the Texas Veterans' Land Bond Program, a program that had been continuously in effect in substantially the same form for more than 30 years before the enactment of the 1984 Act).

or a user of bond-financed property whether the use is direct or indirect. In general, a person is a user of bond proceeds if that person's use of any facility financed with those proceeds is other than as a member of the general public. As under present-law rules, a person may be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership of property or (2) actual or beneficial use of property pursuant to a lease, a management contract, or an arrangement such as a take-or-pay or output contract. (*See*, Treas. Reg. sec. 1.103-7(b)(3) and (c).)

Concept of loan

In addition to the concept of use, present law uses the concept of loan to determine whether interest on bonds of qualified governmental units is tax-exempt (i.e., the private loan bond restriction). A loan may result from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction, as opposed to its form. For example, a lease or other contractual arrangement (e.g., a management contract or an output or take-or-pay contract) may in substance constitute a loan even if on its face, such an arrangement does not purport to involve the lending of bond proceeds.

The concepts of loan and use are related in that in every case in which a loan is present, the borrower is a user of bond proceeds or bond-financed property. On the other hand, certain limited uses of bond proceeds or bond-financed property may not give rise substantively to a loan.

Exceptions for certain bonds for nongovernmental persons

Industrial development bonds

As indicated above, IDBs are obligations issued as part of an issue (1) more than 25 percent of the proceeds of which are to be used in a trade or business carried on by a nonexempt person (i.e., any person other than a qualified governmental unit or a section 501(c)(3) organization), and (2) the payment of a major portion of principal or interest on which is derived from or secured by money or property used in a trade or business. Interest on IDBs is tax-exempt only if the bonds are issued to finance certain specified exempt activities, are used for development of industrial park sites, or are exempt small issues.

Exempt-activity IDBs

One of the exceptions pursuant to which interest on IDBs is tax-exempt is where the proceeds of the bonds are used to finance an exempt activity. Under present law, the following exempt activities are eligible for tax-exempt financing:

(1) *Airports.*—Tax-exempt IDBs may be issued for airports (including related storage or training facilities) (sec. 103(b)(4)(D)). Treasury Department regulations provide that airport property eligible for tax-exempt financing includes facilities that are directly related and essential to servicing aircraft, enabling aircraft to take off and land, or transferring passengers or cargo to or from aircraft

(e.g., terminals, runways, hangars, loading facilities, repair shops, and radar installations). The regulations further provide that airports include other functionally related and subordinate facilities located at or adjacent to the airport which are of a character and size commensurate with the character and size of the airport in question. For example, a hotel at or adjacent to an airport may be financed with exempt-activity IDBs under present law if the number of guest rooms is reasonable in relation to the size of the airport (taking into account current and projected passenger usage) and the number and size of meeting rooms (if any) is in reasonable proportion to the number of guest rooms. A maintenance hangar for airplanes similarly is treated as a related structure; however, an office or a computer serving a regional function of an airline company is not functionally related property (Treas. Reg. sec. 1.103-8(e)(2)(ii)).

In addition to hotels, the Treasury regulations specify that airport facilities eligible for tax-exempt financing include ground transportation, parking areas, and restaurants and retail stores located in terminal buildings. Finally, noise abatement land (i.e., land adjacent to an airport that is impaired by a significant level of airport noise) may be treated as part of an airport under specified circumstances.

(2) *Docks and wharves.*—Exempt-activity IDBs may be used to provide docks and wharves (including related storage and training facilities). Docks and wharves include the structure alongside which a vessel docks, equipment needed to discharge cargo and passengers from the vessel (e.g., cranes and conveyers), harbor dredging activities, and related storage, handling, office, and passenger areas (Treas. Reg. sec. 1.103-8(e)(2)(iii)). Related storage facilities include adjacent grain elevators, warehouses, or oil and gas storage tanks (Treas. Reg. sec. 1.103-8(e)(3)).

(3) *Mass commuting facilities.*—Mass commuting facilities eligible for IDB financing include real property, machinery, equipment, and furniture serving bus, subway, rail, ferry, or other commuters on a day-to-day basis. Mass commuting facilities also include terminals and functionally related and subordinate facilities such as parking garages, car barns, and repair shops. (Treas. Reg. sec. 1.103-8(e)(2)(iv)).[8]

(4) *Facilities for the furnishing of water.*—Facilities for the furnishing of water qualify for tax-exempt IDB financing, if (a) the water is or will be made available on reasonable demand to the general public (including electric utility, industrial, agricultural, or commercial users), and (b) either the facilities are governmentally operated or the rates have been established or approved by a Federal agency or by a State or local governmental unit (including a public service or public utility commission) (sec. 103(b)(4)(G)). Water facilities for this purpose include artesian wells, reservoirs, dams, related equipment and pipelines (Treas. Reg. sec. 1.103-8(h)). Qualifying water facilities include facilities providing water for irrigation purposes.

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[8] Tax-exempt financing for mass commuting vehicles (as opposed to terminals, etc.) previously was authorized as an exempt activity; that authorization expired for bonds issued after 1984.

(5) *Sewage disposal facilities.*—Tax-exempt IDBs are available for sewage disposal facilities, including any property used for the collection, storage, treatment, utilization, processing, or final disposal of sewage (sec. 103(b)(4)(E) and Treas. Reg. sec. 1.103-8(f)(2)(i)).

(6) *Solid waste disposal facilities.*—Tax-exempt IDBs also are available to finance certain solid waste disposal facilities. Treasury Department regulations provide that solid waste disposal facilities for this purpose include property (or a portion of property) used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Solid waste is defined to include garbage, refuse, and other discarded solid materials (including materials resulting from industrial, commercial, and agricultural operations, and from community activities). The term does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved material in irrigation return flows, or other common water pollutants. No material may qualify as solid waste unless it is useless, unused, unwanted, or discarded and has no market or other value at the place at which it is located (Treas. Reg. sec. 1.103-8(f)(2)(ii)).

In the case of property which has both a solid waste disposal and another function (e.g., a recycling or resource recovery project), tax-exempt IDB financing is available only for the portion of the cost of the property that is allocable to solid waste disposal. Where materials or heat are recovered from a disposal process, tax-exempt IDB financing is available for the processing of such materials or heat into usable form, but not for further processing which converts the materials or heat into other products (e.g., electricity) (Temp. Treas. Reg. sec. 17.1).

(7) *Projects for multifamily residential rental property.*—Tax-exempt IDBs may be issued to finance projects for multifamily residential rental property, if at least 20 percent of the units in the project (15 percent, in targeted areas) are "set aside" for occupancy by low- or moderate-income individuals (sec. 103(b)(4)(A)).[9] The determination of low- or moderate-income is made by reference to rules established under section 8 of the Housing Act of 1937 for determining lower-income families, except that the percentage of family median gross income that qualifies as low or moderate is 80 percent.

Present Treasury Department regulations do not provide specifically that adjustments for family size are to be made in determining the applicable percentage of median gross income to be used under the Code restrictions. However, the Treasury Department has proposed regulations requiring family size adjustments, effective for bonds issued after December 31, 1985 (Prop. Treas. Reg. sec. 1.103-8(b), 50 *Fed. Reg.* 216 at 46303 (Nov. 7, 1985)). The regulations further provide that no unit may be considered as occupied by low- or moderate-income individuals if all of its occupants are students (as determined under sec. 151(e)(4)), no one of whom is entitled to file a joint income tax return.

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[9] Bonds issued under section 11b of the United States Housing Act of 1937 that are in substance IDBs must satisfy all Internal Revenue Code requirements applicable to IDBs for multifamily residential rental property, in order to qualify for tax-exemption.

The set-aside requirement must be satisfied continuously during a qualified project period (i.e., 20 percent of the housing units must continue to be occupied by qualifying low- or moderate-income tenants). If a tenant qualifies as a low- or moderate-income tenant when he or she moves into an apartment, however, that tenant continues to be treated as a low- or moderate-income tenant throughout the period the apartment is occupied, regardless of subsequent increases in the tenant's income. A unit vacated by a low- or moderate-income tenant also continues to be treated as occupied by such a tenant until reoccupied, other than for a temporary period (not exceeding 31 days).

In addition to satisfying tenant income requirements, bond-financed multifamily residential rental property also is required to remain as rental housing throughout the qualified project period.

The term qualified project period means the period beginning on the first date on which at least 10 percent of the units in the project are first occupied (or the date on which the IDBs are issued) and ending on the later of the date: (1) that is 10 years after the date on which at least 50 percent of the units are first occupied; (2) that is a number of days after the date or which any units are occupied equal to 50 percent of the number of days in the term of the bonds having the longest maturity; or (3) on which any assistance provided to the project under section 8 of the Housing Act of 1937 terminates.

As indicated above, the set-aside requirement is reduced from 20 percent to 15 percent in targeted areas. For purposes of this reduced set-aside requirement, the term targeted area means (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under statutory criteria (sec. 103A(k)(3)).

Failure to comply with the set-aside and rental requirements at any time during the qualified project period results in the interest on the bonds becoming taxable, retroactive to the date of issue. Under Treasury Department regulations, however, if noncompliance with the requirements is corrected within a reasonable period (60 days) after the noncompliance reasonably should have been discovered, the tax-exempt status of the bond interest is not affected (Treas. Reg. sec. 1.103-8(b)(6)).

(8) *Additional exempt activities.*—Present law also allows tax-exempt financing for certain sports facilities, convention or trade show facilities, parking facilities, facilities for the local furnishing of electricity or gas, qualified hydroelectric generating facilities,[10] local district heating and cooling facilities, and air or water pollution control facilities. Additionally, tax-exempt bonds may be used to finance the acquisition or development of land as a site for an industrial park.

Public use requirement for all exempt-activity IDB-financed facilities.—Treasury Department regulations require that to qualify as an exempt facility, a facility must serve or be available on a regular basis for general public use, as contrasted with similar types

[10] This exemption is scheduled to expire generally after 1985.

of facilities that are constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses. For example, the regulations provide that a private dock or wharf serving only a single manufacturing plant would not qualify as a facility for general public use; however, a dock or wharf at a port that serves the general public (or a hangar or repair facility at a municipal airport) would qualify even if the specific bond-financed property is owned by, or leased to, a non-exempt person, provided that such nonexempt person directly serves the general public (e.g., a common carrier of passengers and/or cargo). Similarly, an airport owned or operated by a nonexempt person for general public use satisfies the public use requirement; however, a landing strip which, by reason of a formal or informal agreement or by reason of geographic location, will not be available for general public use does not satisfy the requirement (Treas. Reg. sec. 1.103-8(a)(2)).

Under the Treasury Department regulations, sewage or solid waste disposal facilities, as well as air or water pollution control facilities, are considered to satisfy the general public use requirement even though they may be part of a nonpublic facility, such as a manufacturing facility exclusively used in the trade or business of a nonexempt person.

Small-issue IDBs

In general.—Present law also permits tax-exemption for interest on small issues of IDBs, the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property used in privately owned and operated businesses (the small-issue exception).[11] The small-issue exception is scheduled to expire generally after December 31, 1986; small-issue IDBs to finance manufacturing facilities may be issued under the exception for an additional two years, through 1988.

Small-issue IDBs are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.[12] In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10 million limitation, previous capital expenditures) are taken into account if (1) they are with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the small-issue IDBs, and (2) the principal users of both facilities are the same, or two or more related, persons.

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[11] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide multifamily residential rental property. Thus, IDBs to finance residential rental property must be issued under the exempt-activity IDB exception, discussed above.

[12] In the case of facilities with respect to which an Urban Development Action Grant (UDAG grant) is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

Capital expenditures are not considered for purposes of the $10 million limit if the expenditures (1) are made to replace property destroyed or damaged by fire, storm, or other casualty; (2) are required by a change in Federal, State, or local law made after the date of issue; (3) are required by circumstances that reasonably could not be foreseen on the date of issue;[13] or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

$40 million limitation.—Interest on small-issue IDBs is taxable if the aggregate face amount of all outstanding tax-exempt IDBs (both exempt-activity and small-issue) that would be allocated to any beneficiary of the small-issue IDBs exceeds $40 million. Bonds that are to be redeemed with the proceeds of a new issue are not considered.

For purposes of the $40 million limitation, the face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a three-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns bond-financed property and other persons are principal users, or when owners and/or principal users change during the three-year test period.[14] Once an allocation to a test-period beneficiary is made, that allocation remains in effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property.

Mortgage subsidy bonds and mortgage credit certificates

Mortgage subsidy bonds (MSBs) are bonds issued to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds (sec. 103A). Before 1980, no restrictions were placed on the issuance of mortgage subsidy bonds. The Mortgage Subsidy Bond Tax Act of 1980 limited tax-exemption to two types of MSBs, qualified veterans' mortgage bonds and qualified mortgage bonds.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to make mortgage loans to veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984, and issuance is subject to State volume limitations based on issuance before that date. The States qualifying under this restriction are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences and may not be made to acquire or replace existing mortgages.

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds may be made only to veterans who served on active duty before 1977, and who apply for the loan before the later

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[13] The excluded expenditures under this exception may not exceed $1 million.

[14] If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of IDBs that cause the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other, previously issued, IDBs is not affected.

of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.[15] These restrictions will lead to the eventual elimination of qualified veterans' mortgage bonds.

Qualified mortgage bonds

In addition to the rules applicable to all tax-exempt bonds, qualified mortgage bonds are subject to various restrictions, including a separate set of State volume limitations; borrower eligibility and targeting rules; special arbitrage restrictions; information reporting requirements; and an annual policy statement requirement. Authority to issue qualified mortgage bonds is scheduled to expire after December 31, 1987.

Borrower eligibility requirements.—All lendable proceeds (i.e., total proceeds less costs of issuance and proceeds invested as part of a reasonably required reserve or replacement fund) of qualified mortgage bonds must be used to finance the purchase, or qualified improvement or rehabilitation, of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must be reasonably expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. The term single-family residence includes two-, three-, and four-family residences if (1) the units in the residence are first occupied at least five years before the mortgage is executed, and (2) one unit in the residence is occupied by the owner of the units.

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new, rather than existing, mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Assumptions of loans financed with qualified mortgage bond proceeds are permitted if the assuming mortgagor satisfies the principal residence, first-time homebuyer, and purchase price requirements, discussed below.

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who have had no present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage loan is executed. This first-time homebuyer requirement does not apply with respect to mortgagors in three situations: (1) mortgagors of residences that are located in targeted areas (as described below); (2) mortgagors who receive qualified home improvement loans; and (3) mortgagors who receive qualified rehabilitation loans.

All mortgage loans provided from the lendable proceeds of an issue (except qualified home improvement loans) must be for the purchase of residences the acquisition cost of which does not exceed 110 percent of the average area purchase price applicable to that residence. This limit is increased to 120 percent of the average area purchase price in targeted areas. The determination of average area purchase price is made separately (1) with respect to new and

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[15] Sec. 611(c) of the Deficit Reduction Act of 1984 incorrectly provided that this date was January 1, 1985. Title XIV of the bill, relating to technical corrections to that Act, corrects this reference.

previously occupied residences, and (2) with respect to one-, two-, three-, and four-family residences.

Targeted area requirement.—At least 20 percent of the lendable proceeds of each qualified mortgage bond issue (but not more than 40 percent of the average mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term targeted area is defined as (1) a census tract in which 70 percent or more of the resident families have incomes that are 80 percent or less of the statewide median family income, or (2) an area designated as an area of chronic economic distress using statutorily defined criteria (described in sec. 103A(k)(3)).

Annual policy statement.—Issuers of qualified mortgage bonds and mortgage credit certificates (MCCs) (described below) must publish and submit to the Treasury Department an annual report detailing the policies that the jurisdiction intends to follow in the succeeding year with respect to these programs. This report must be published and submitted before the last day of the year preceding the year in which any such bonds are issued. A public hearing must be held before publication and submission of the report.

Mortgage credit certificate alternative to qualified mortgage bonds

Qualified governmental units may elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for at least 10 percent (but not more than 50 percent) of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds, and that elects to exchange $100 million of that bond authority, may distribute an aggregate amount of MCCs equal to $20 million.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness (under sec. 163(a)) is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

Authority to issue mortgage credit certificates expires after December 31, 1987, together with the authority to issue qualified mortgage bonds.

Bonds for section 501(c)(3) organizations

Under present law, religious, charitable, scientific, educational, and similar organizations (described in sec. 501(c)(3)) are treated as exempt persons with respect to the use of bond proceeds. Thus, State and local governments may issue tax-exempt bonds to finance the activities of section 501(c)(3) organizations on a basis similar to that which applies for activities of the governments themselves. The beneficiaries of this type of financing generally are private, nonprofit hospitals and private, nonprofit colleges and universities. This financing is not available with respect to activities of section 501(c)(3) organizations which constitute unrelated trades or businesses.

Student loan bonds

Qualified governmental units may issue tax-exempt bonds to finance student loans. Issuance of these bonds is permitted only in connection with loans guaranteed under the Guaranteed Student Loan (GSL) and Parent Loans for Undergraduate Students (PLUS) programs of the United States Department of Education. The GSL and PLUS programs provide three direct Federal Government subsidies for qualified student loans. First, the Department of Education guarantees repayment of qualified student loans. Second, that Department pays special allowance payments (SAPs) as an interest subsidy on qualified student loans, so that the student-borrowers will be charged lower interest rates on the loans. Third, the Department pays an additional interest subsidy on qualified loans while the student-borrowers attend school.

Bonds issued by State or local governments in connection with programs other than the GSL or PLUS programs (supplemental student loan bond programs) generally are not tax-exempt under present law.

Tax-exempt bonds authorized by Federal statutes other than the Internal Revenue Code

Several Federal statutes other than the Internal Revenue Code authorize issuance of bonds on which the interest is tax-exempt.[16] Examples of these "non-Code" bonds are housing bonds issued under section 11b of the United States Housing Act of 1937, and certain bonds issued by the District of Columbia and United States possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam). Since January 1, 1984, non-Code bonds have been subject to the same restrictions as apply to Code bonds, the proceeds of which are used for a similar purpose.

Volume limitations

Three separate volume limitations affect the aggregate volume of bonds for nongovernmental persons that each State (including U.S. possessions) may issue during any calendar year. These limitations apply separately to (1) IDBs and student loan bonds, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds.

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[16] The 1984 Act provided that grants of tax-exemption may only be made in a revenue Act, effective after December 31, 1983.

IDBs and student loan bonds

Volume limitation

The annual volume of most IDBs and all student loan bonds that a State and local issuers therein, may issue is limited to the greater of (1) $150 for every individual who is a resident of the State (determined by reference to the most recent estimate of the State's population released by the Bureau of the Census as of the beginning of the calendar year to which the limitation applies), or (2) $200 million. The $150 per capita limitation continues through 1986, at which time that amount is scheduled to be reduced to $100 to reflect the scheduled termination of small-issue IDBs for other than manufacturing facilities. (The $200 million limitation will not be reduced at that time.) For purposes of the volume limitation, the District of Columbia is treated as a State (and is entitled to the $200 million safe harbor limitation); however, U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are limited to the $150 per capita amount.

This volume limitation does not apply to IDBs the proceeds of which are used to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)). This exception includes public housing program obligations issued under section 11(b) of the United States Housing Act of 1937. The volume limitation also does not apply to IDBs the proceeds of which are used to finance convention or trade show facilities or airports, docks, wharves, or mass commuting facilities (sec. 103(b)(4)(C) and (D)), but only if the property financed by the IDBs is owned by or on behalf of[17] a governmental unit. The exception from the volume limitation does not apply to parking facilities financed with IDBs (under sec. 103(b)(4)(D)). However, parking facilities that are functionally related and subordinate to a facility that qualifies under the exception (e.g., airport parking facilities) are included within the exception if the parking facilities satisfy the same requirements for tax-exemption (i.e., no nongovernmental ownership) as the facility to which they are subordinate.

For purposes of this exception from the volume limitations for certain transportation facilities, IDB-financed property is treated as governmentally owned if no person is entitled to cost recovery deductions or an investment tax credit for any portion of the property. An election to forego cost recovery deductions and investment credit results in the property being treated as governmentally owned under this provision even though the property may be considered privately owned using general Federal income tax concepts of ownership. Bond-financed property may qualify for the exception even if the governmental unit's obligation to pay interest and principal on the bonds is limited to revenues from fees collected from users.

For purposes of the volume limitation, student loan bonds include any obligation that is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly to finance loans to individuals for educational expenses.

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[17] *See*, Rev. Proc. 63-20, 1963-2 C.B. 754.

The volume limitation does not apply to obligations that are neither IDBs nor student loan bonds (e.g., bonds issued for section 501(c)(3) organizations for use other than in unrelated trades or businesses, and bonds issued to finance general governmental operations) or to bonds that are subject to either of the other sets of State volume limitations.[18]

Qualified mortgage bonds

The aggregate annual volume of qualified mortgage bonds that a State, and local issuers therein, may issue is limited to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. This volume limitation is separate from, and in addition to, the volume limitations imposed with respect to student loans bonds and most IDBs (discussed above) and qualified veterans' mortgage bonds (discussed below).

Qualified veterans' mortgage bonds

The volume of qualified veterans' mortgage bonds that a qualifying State may issue in any calendar year is limited to an amount equal to (1) the aggregate amount of such bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984,[19] divided by (2) the number (not to exceed five) of calendar years after 1979 and before 1985 during which the State actually issued qualified veterans' bonds.[20] For purposes of this limitation, certain obligations of one year or less that are used to finance property taxes on residences financed with these bonds are taken into account at 1/15th of their actual principal amount.

Allocation of volume limitations

IDBs, student loan bonds, and qualified mortgage bonds may be issued both by States and by local issuers subject to State law.[21] The Code permits each State, by statute, to allocate its bond volume limitation in any manner among the State and local issuers therein.[22] In the absence of State action, the Code provides that bond authority is divided equally between the State and local issuers therein, with local jurisdictions receiving allocations based on their relative populations (or, in the case of qualified mortgage bonds, based on relative mortgage activity). Under both sets of volume limitations, governors were given authority to establish

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[18] The State of Texas has a program called the Texas Veterans' Land Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount that is not a major portion of the proceeds, are used, for example, for the acquisition of land for recreational or other nontrade or business purposes of its owners, the issue is not subject to this State volume limitation.

[19] This determination is made without regard to bonds issued during the calendar year (or portion thereof) during this period when the lowest volume of such bonds was issued.

[20] This determination is made without regard to any bonds issued by the State after June 22, 1984.

[21] Qualified veterans' mortgage bonds are general obligation bonds of the issuing State. Thus, these bonds may be issued only by the State itself.

[22] A special rule prevents a State from reducing the bond authority allocation of a constitutional home rule city. In the case of such a city, the Mayor generally is treated as a governor and the city council as a State legislature.

rules for allocating this bond volume during an interim period following their enactment.

Present law requires each person allocating a State's (or local issuer's) IDB or student loan bond volume limitation to certify that the allocation is not made in consideration of any bribe, gift, or campaign contribution.

Carryforward of bond authority

In general, each State's annual volume limitation must be allocated to bonds issued during the calendar year to which the authority relates. Under a special election, however, IDB and student loan bond volume may be carried forward for up to three years (six years in the case of certain pollution control projects) for a specifically identified exempt-activity IDB project, or for the general purpose of making student loans. Bond authority may not be carried forward for the purpose of issuing small-issue IDBs, qualified mortgage bonds, or qualified veterans' mortgage bonds.

Arbitrage restrictions

General restrictions applicable to all bonds

Permissible arbitrage profits

Interest on any otherwise tax-exempt obligation is taxable if the obligation is an arbitrage bond. An arbitrage bond is defined as an obligation that is part of an issue more than 15 percent of the proceeds of which are reasonably expected to be used (directly or indirectly) to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used).

The determination of whether investment of bond proceeds in materially higher yielding obligations is reasonably expected is made on the date the bonds are issued. The Internal Revenue Service has ruled that intentional acts to create arbitrage occurring after bonds are issued are not protected by the reasonable expectations test. (*See*, Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47.) Exceptions are provided for materially higher yielding obligations that do not exceed a minor portion (15 percent) of the bond proceeds described above, and for obligations held for certain initial temporary periods.

Treasury Department regulations provide rules for determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. These regulations apply different arbitrage restrictions to acquired purpose obligations and acquired nonpurpose obligations acquired with the proceeds of tax-exempt bonds. Acquired purpose obligations are obligations acquired to carry out the purpose of the bond issue. All other obligations acquired with bond proceeds are acquired nonpurpose obligations.

Permissible arbitrage on acquired purpose obligations (other than for bonds issued in connection with certain governmental programs such as student loan bonds) generally is limited, so that the issuer may earn a spread between the yield on the bonds and the

yield on acquired purpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming, or selling the obligation to the bond user. Permissible arbitrage on acquired nonpurpose obligations is restricted to an amount not exceeding 0.125 percentage points plus certain costs. Additional yield restrictions apply to refundings, overissuances, investments in sinking funds, and other indirect and replacement proceeds of a bond issue.

There are two principal exceptions to the general arbitrage rules. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use, whether held by the issuer or the user of bond proceeds. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percentage points with respect to acquired obligations. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. All amounts held in such a reserve fund are applied against the 15 percent minor portion that may be invested without regard to yield restrictions. Since an issue may not be increased deliberately to take advantage of the minor portion rule, reserve funds are the most important example of a minor portion on which unlimited arbitrage earnings are permitted.

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage on purpose obligations that are acquired in connection with the program (acquired program obligations) generally is limited to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (1) 1.5 percentage points plus reasonable administrative costs, or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments (SAPs) made by the Department of Education are not taken into account in determining yield on student loan bonds. If student loan repayments are placed in a revolving fund, a new temporary period commences when each deposit to the fund is made.

Present law contains no specific period during which bond proceeds must be expended for the exempt purpose of the issue (e.g., the exempt facility, mortgage loans, etc.). In order to qualify for the temporary exception from the aribitrage restrictions, borrowers must, however, proceed with due diligence to accomplish the purpose of the borrowing. Additionally, borrowers must satisfy an expenditures test under which established percentages of bond proceeds must be spent by a specified time and must incur a substantial, binding obligation to acquire the property to be financed, generally within six months of the date of issue as a condition of being allowed a temporary period when unlimited arbitrage profits may be earned (Treas. Reg. sec. 1.103-14(b)). Finally, Treasury regulations provide that if an artifice or device is employed in connection with an issue, the bonds are arbitrage bonds (Treas. Reg. sec. 1.103-13(j)).

Determination of bond yield

The determination of whether bonds are arbitrage bonds depends on a comparison of the yield on the bonds and the yield on the acquired obligations. Certain adjustments are permitted that either increase bond yield or decrease the yield or acquired purpose obligations. The case of *State of Washington* v. *Commissioner*, 692 F.2d 128 (D.C. Cir., 1982), held that bond yield is the discount rate at which the present value of all payments of principal and interest on the bonds equals the net proceeds of the issue after deduction of the costs of issuing the bonds. Because costs are deducted pursuant to the *State of Washington* decision in determining net proceeds, there is a corresponding increase in the bond yield. Therefore, under this case, the bond issuer is permitted a higher yield on the investment of bond proceeds and may, in effect, pay issuance costs out of arbitrage profits.

Additional arbitrage restrictions on most IDBs

Rebate requirement

IDBs, other than IDBs for multifamily residential rental property, are subject to additional arbitrage restrictions. Under these additional restrictions, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of the IDBs must be rebated to the Federal Government. No rebate is required if all gross proceeds of an issue are expended within six months of the issue date for the governmental purpose for which the bonds are issued. Additionally, if less than $100,000 is earned on a bona fide debt service fund with respect to an issue in a bond year, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider those earnings when determining if a rebate otherwise is due with respect to the bonds.

For purposes of these additional IDB restrictions, nonpurpose obligations generally include all investments other than those specifically made to carry out the purpose for which the IDBs are issued. Gross proceeds include the original proceeds of the borrowing, the return on investments of the bond proceeds, and amounts used or available to pay debt service on the bonds. Arbitrage profits that must be rebated include both income earned on investment of the bond proceeds in nonpurpose obligations and earnings on that income.

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds.

Limitation on investment in nonpurpose obligations

In addition to the rebate requirement, the amount of IDB proceeds that may be invested in nonpurpose obligations at a yield above the bond yield generally is restricted to an amount equal to 150 percent of the debt service. This limitation does not apply to amounts invested for certain initial temporary periods or to amounts held in a bona fide debt service fund. Debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include

payments with respect to bonds that are retired before the beginning of the bond year.

Determination of bond yield

Under the additional IDB arbitrage restrictions, the determination of bond yield is made in a manner consistent with the original issue discount rules of the Code (secs. 1273 and 1274). Bond yield is based on the initial offering price to the public (excluding underwriters, dealers, and brokers). The yield on acquired purpose obligations is calculated by excluding payments having a present value equal to the costs of issuing, carrying, or repaying the bonds, the underwriter's spread, and the costs of purchasing, carrying, redeeming, or selling acquired obligations. The bond issuer therefore is permitted to recover these costs through the higher yield permissible on acquired purpose obligations. Unlike under the rule in *State of Washington* v. *Commissioner, supra.*, the bond issuer may not increase bond yield to take costs of issuance into account.

Additional arbitrage restrictions on qualified mortgage bonds

Additional arbitrage restrictions also are imposed on qualified mortgage bonds.[23] These restrictions apply both to arbitrage earned on mortgage investments and on nonmortgage investments.

Mortgage investments

The effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for all mortgage loans financed with the proceeds of the issue. Consequently, the effective interest rate on some mortgage loans is permitted to be greater than 1.125 percentage points above the yield of the issue, if other mortgages have a lower effective interest rate.

Nonmortgage investments

As under the additional arbitrage restrictions for most IDBs, the amount of qualified mortgage bond proceeds that may be invested at an unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until the proceeds are needed for mortgage loans and for temporary periods related to debt service. Arbitrage earned on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Determination of bond yield

Bond yield is determined for purposes of the additional arbitrage restrictions on qualified mortgage bonds using the same method as under the additional restrictions on most IDBs.

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[23] Qualified veterans' mortgage bonds are not subject to any additional arbitrage restrictions beyond the restrictions imposed on tax-exempt bonds generally.

Additional arbitrage restrictions on student loan bonds

The 1984 Act directed the Congressional Budget Office and the General Accounting Office to conduct a study of appropriate additional arbitrage restrictions to apply to student loan bonds, and to report to Congress by April 18, 1985.[24] The 1984 Act further directed the Treasury Department to adopt new arbitrage restrictions on these bonds, and provided that restrictions similar to the additional restrictions adopted in that Act for most IDBs may apply to student loan bonds. Thus, Congress anticipated that earnings on debt service funds could be limited and that rebate requirements could be imposed with respect to nonpurpose obligations. Additionally, the 1984 Act provided that these regulations could eliminate the rule providing special treatment of SAPs included in the general arbitrage restrictions applicable to all tax-exempt bonds. These new arbitrage restrictions generally would apply to bonds issued six months after their adoption.

Advance refundings

In the case of IDBs and mortgage subsidy bonds,[25] interest on refunding bonds is tax-exempt only if the refunding bonds are issued no more than 180 days before the refunded issue is redeemed (i.e., the refunded and the refunding issues may not be outstanding simultaneously for more than 180 days). Interest on refunding bonds that are outstanding for more than 180 days before refunded IDBs or mortgage subsidy bonds are redeemed (advance refunding bonds) generally does not qualify for tax-exemption (Prop. Treas. Reg. sec. 1.103-7(e)). Advance refundings are permitted in the case of bonds the proceeds of which are used for general government operations or by charitable organizations (described in Code sec. 501(c)(3)).

For purposes of these rules, a refunding issue is an issue used to pay principal, interest, or call premium on a prior issue, together with reasonable incidental costs of the refunding. An issue is not treated as a refunding issue for purposes of the restriction on advance refunding if the prior issue is an issue of IDBs with a term of less than 3 years (including the term of any prior refunded notes) and was sold in anticipation of permanent financing. Thus, these short-term obligations may be refunded more than 180 days before the refunded bonds are redeemed (Prop. Treas. Reg. sec. 1.103-7(e)).

A refunding issue (other than an advance refunding) generally is considered to be used for the same purposes as the issue being refunded. For example, if the refunded issue was used for an exempt activity under the rules applicable to IDBs, the refunding obligation generally also is considered to be so used.

Additional restrictions on IDBs

Application of IDB proceeds to purpose of borrowing

Under present law, exempt-activity IDBs may be used to finance an exempt facility, and additionally, any land, building, or other property that is functionally related and subordinate to the exempt

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[24] This study has not yet been submitted to Congress.

[25] This restriction applies both to qualified mortgage bonds and to qualified veterans' mortgage bonds.

facility (Treas. Reg. sec. 1.103-8(a)(3)). Functionally related and subordinate facilities are illustrated in the discussion of exempt-activity IDBs, above.

Exempt-activity IDBs qualify for tax-exemption if substantially all of the bond proceeds are used to finance one or more of the statutorily exempt categories of facilities including functionally related and subordinate property. Treasury Department regulations provide that the use of 90 percent or more of bond proceeds to provide exempt facilities satisfies the substantially all requirement (Treas. Reg. sec. 1.103-8(a)(1)).

Public approval requirement

For interest on IDBs to be tax-exempt, a public hearing must be held, and the issuance of the bonds must be approved by an elected public official or elected legislative body. As an alternative to these requirements, issuance of the IDBs may be approved by a voter referendum. These restrictions apply to all IDBs, including IDBs exempt from the State volume limitations; however, they do not apply to student loan bonds or to other non-IDB tax-exempt bonds.

If the bond-financed property is located outside of the issuing jurisdiction, the public approval requirement generally must be satisfied by the issuing jurisdiction and all other jurisdictions in which the bond-financed property (or parts thereof) will be located.

The public approval requirement is satisfied, however, if one governmental unit, having jurisdiction over all the property being financed, holds a hearing and approves issuance of the bonds (e.g., a hearing held at the State level followed by governor's approval of the issue). Additionally, in the case of governmentally owned airports, this requirement may be satisfied by approval by the governmental unit that issues the bonds and owns the bond-financed property.

Restriction on maturity of IDBs

The average maturity of all IDBs may not exceed 120 percent of the economic life of the property to be financed. For example, if the proceeds of an issue of IDBs are used to purchase assets with an average estimated economic life of 10 years, the average maturity for the bonds may not exceed 12 years. The economic life of a facility is measured from the later of the date the bonds are issued or the date the assets are placed in service.

For purposes of this restriction, the economic life of facilities is determined on a case-by-case basis. However, the legislative history of the restriction states that, in order to provide guidance and certainty, the administrative guidelines used to determine useful lives for depreciation purposes before enactment of the ACRS system (i.e., ADR midpoint lives and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets.[26]

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[26] *See*, H. Rpt. No. 97-760, 97th Cong., 2d Sess. (August 17, 1982), p. 519.

Restrictions on acquisition of land and existing property

Present-law includes two restrictions on the circumstances under which land may be financed with IDBs.

Nonagricultural land

Interest on IDBs is taxable if more than 25 percent of the proceeds of the issue of which the IDBs are a part is used to finance the acquisition of any interest in nonagricultural land. This restriction applies both to exempt-activity and to small-issue IDBs. The 25-percent restriction is increased to 50 percent in the case of IDBs issued to finance an industrial park (described in sec. 103(b)(5)). An additional exception to the land acquisition rules is provided for certain land acquired by a public agency in connection with an airport, mass transit, or port development project (described in sec. 103(b)(4)(D)) for a noise abatement, wetland preservation, future use, or other public use, but only if there is no other significant use of the land after its acquisition and before the expansion occurs.

Agricultural land

Agricultural land may be financed with IDBs if two conditions are satisfied.[27] First, loans for agricultural land must be limited to first-time farmers, and second, each first-time farmer is limited to a maximum of $250,000 of IDB-financing. A first-time farmer is an individual who has not at any time had any direct or indirect ownership in substantial farmland in the operation of which the individual or the individual's spouse or dependent children have materially participated. Substantial farmland for this purpose includes any parcel of land (1) that is greater than 15 percent of the median size of a farm in the county in which the land is located, or (2) the fair market value of which exceeds $125,000 at any time when the land is held by the individual in question.

A *de minimis* portion of IDB financing provided under this exception may be used for the acquisition of used farming equipment (without regard to the restriction on financing existing property, discussed below). Only equipment acquired within one year after acquisition of the farmland is eligible for tax-exempt financing under this exception.

Existing property

Tax-exempt IDBs generally may not be used to finance the acquisition of previously used property. As with the restrictions on the acquisition of land, this restriction applies both to exempt-activity and small-issue IDBs. An exception is provided, however, permitting the acquisition of an existing building (and equipment for such a building) if expenditures for rehabilitation of the building and equipment exceed 15 percent of the amount of bonds issued for acquisition of the building and related equipment. A parallel exception also applies to nonbuilding structures (e.g., dry docks), but in such cases, the rehabilitation expenditures must exceed 100 percent of the bond-financing.

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[27] Agricultural land is eligible for financing only under the small-issue exception.

Qualified rehabilitation expenditures generally include any amount chargeable to capital account that is incurred in connection with the rehabilitation project. Only expenditures incurred before the date that is two years after the date the building is acquired, or (if later) the date the bonds are issued, are qualified rehabilitation expenditures. In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures also include the expenses of rehabilitating existing equipment previously used to perform the same function in the building, or replacing the existing equipment with equipment having substantially the same function.

Ownership of and cost recovery deductions for bond-financed property

Ownership requirements

Under present law, qualification for tax-exempt financing generally is determined by reference to the type of activity being financed, rather than the ownership of bond-financed property. Thus, bond-financed property may be owned by a governmental unit; by a nongovernmental, exempt person (in the case of bond-financed property for section 501(c)(3) organizations); or by a nongovernmental, nonexempt person (in the case of property financed with IDBs and mortgage subsidy bonds).

Governmental ownership of bond-financed property is a condition for excluding IDBs for certain transportation facilities (e.g., airports) from the present-law statewide volume limitations, described above. As discussed above, however, economic or tax ownership is not required for purposes of this exception from the volume limitation. Rather, property is deemed to be owned by a governmental unit if an election is made by the nongovernmental beneficiary of tax-exempt financing to forego cost recovery deductions and investment tax credit.

Cost recovery deductions

The cost of property that is used in a trade or business or otherwise for the production of income, and that has a useful life of more than one year, may be recovered through tax deductions (sec. 168). The present-law Accelerated Cost Recovery System (ACRS) prescribes recovery periods of from 3 years to 19 years. These recovery periods generally are shorter than the economic life of the property. In addition, the ACRS system prescribes a cost recovery method that further accelerates cost recovery by permitting larger deductions in the early years of the recovery period.

Under present law, the cost of property financed with tax-exempt bonds is eligible for recovery over the prescribed ACRS periods, but generally is not eligible for the accelerated cost recovery methods provided by ACRS (sec. 168(f)(12)). Projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to this restriction, and therefore may qualify for both tax-exempt financing and accelerated ACRS deductions.

Information reporting requirements

Issuers of IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and all mortgage subsidy bonds must report certain information to the Internal Revenue Service about bonds issued by them during each preceding calendar quarter. This report is due on the 15th day of the second month after the close of the calendar quarter in which the bonds are issued. Interest is taxable on bonds with respect to which the required report is not made.

Reasons for Change

General considerations

The committee is concerned that the large volume of nongovernmental tax-exempt bonds and the accompanying ability of higher income taxpayers to avoid paying income tax erodes confidence in the equity of the tax system, increases the cost of financing traditional government activities, and results in an inefficient allocation of new capital. The committee desires to correct these problems without affecting the ability of State and local governments to issue tax-exempt bonds for general government operations or for the construction and operation of such governmental facilities as schools, highways, government buildings, and governmentally owned and operated sewage, solid waste, water, and electric facilities.

The dollar volume of tax-exempt bonds issued for long-term nongovernmental purposes more than doubled in the three years between 1981 and 1984, from $30.9 billion to $71.7 billion. The committee believes that the volume of these bonds has reached unjustifiably high levels, despite recent Congressional attempts to control that volume. In 1984, these issues represented nearly two-thirds of the total tax-exempt bond market. In 1975, nongovernmental bond volume was less than one-third of the total tax-exempt bond market. Each dollar of nongovernmental bond volume represents an indirect subsidy by the Federal Government for the activities of nongovernmental persons. Absent further restrictions on nongovernmental bonds, the revenue cost of this tax subsidy is estimated to total $68.5 billion over the next five years.

The large volume of tax-exempt bonds for nongovernmental persons affects the equity of the tax system in several ways. First, the equity of the tax system is harmed when high-income taxpayers and corporations have the ability to limit their tax liability by investing in tax-exempt securities. Due to the large volume of nongovernmental tax-exempt obligations, tax-exempt yields are often only slightly less than taxable yields. Taxpayers with high marginal tax rates receive an after-tax yield on tax-exempt bonds much higher than the yield they would receive from investing in taxable bonds. A perception of inequity arises when these investors are able to reduce their tax liability and still receive a very high rate of return by investing in tax-exempt bonds. A smaller supply of bonds for activities of nongovernmental persons will reduce the benefit high marginal tax rate investors receive from investing in tax-exempt bonds.

Second, tax-exempt financing for certain activities of nongovernmental persons results in a misallocation of capital. The efficient allocation of capital requires that the social return from a marginal unit of investment be equal across activities. When there is no difference between the private return on capital and the social return, the output of capital will be maximized only if there is no preferential treatment for investment in certain activities. If the ability of nongovernmental activities to qualify for tax-exempt financing is restricted, capital may be more efficiently allocated.

Further, the large volume of nongovernmental tax-exempt bonds also increases the interest rates that State and local governments must pay to finance their activities. As the total volume of tax-exempt bonds increases, the interest rate on the bonds must increase to attract investment from competing sources. The additional bond volume caused by nongovernmental users in the tax-exempt market thus increases the cost of financing essential government services.

The committee believes the changes made by the bill will help to correct many of the problems in this area. Specific reasons for some of the more significant changes are discussed below.

Bonds for governmental activities

The bill does not restrict issuance of tax-exempt debt for traditional governmental activities. The committee is concerned, however, because under present law, a significant amount of bond proceeds from a governmental issue are being used in many cases by nongovernmental persons for activities which have not been approved specifically by Congress for tax exempt financing. For example, many governmental bond issues under present law are structured to maximize the amount of bond proceeds available for nongovernmental users. Other governmental bond issues are intentionally structured to fail the present-law IDB security interest test, when the bonds otherwise would be considered IDBs and subject to the restrictions that Congress has placed on such conduit financing for nongovernmental persons or would be prohibited altogether. The committee believes that this diversion of governmental bond proceeds to nongovernmental users should be limited, but without setting the threshold amount for treating bonds as being for a nongovernmental person so low that governments would need to be concerned that *de minimis* or incidental usage of government facilities and services by such private users might cause interest on an issue to be taxable.

The bill defines as a nonessential function (i.e., nongovernmental) bond, all bonds where an amount equal to or exceeding the lesser of 10 percent or $10 million of the proceeds is used in a trade or business of any person or persons other than a qualified governmental unit. Additionally, a bond is a nonessential function bond if an amount equal to or exceeding the lesser of 5 percent or $5 million of the proceeds is used for loans to any person or persons other than a qualified governmental unit. The committee believes these rules provide an appropriate limit for preventing the diversion of a significant amount of governmental bond proceeds for conduit financing of nongovernmental users without affecting the availability of tax-exempt financing for traditional governmental activities.

Exceptions for certain nonessential function bonds

The bill continues certain exceptions to the general rule that interest on bonds for nongovernmental persons, referred to collectively, as nonessential function bonds, is taxable.[28] While continuing tax-exempt financing for certain activities of nongovernmental persons, the committee believes it is important to control the total volume of tax-exempt bonds issued for nonessential functions. To accomplish this objective, the bill provides a unified volume limitation on the aggregate annual amount of bonds for nongovernmental persons that each State (including local governments therein) may issue. The committee believes that this unified volume limitation will ensure that the activities for which bonds for nongovernmental persons are issued will be scrutinized more closely by qualified governmental units, and that such bonds will be targeted better to serve those persons for whom the exceptions are intended.

Additionally, while permitting a limited amount of the proceeds of governmental bonds (defined as essential function bonds) to be used by nongovernmental persons, the committee intends that diversion of essential function bond proceeds to such persons be scrutinized strictly by State and local government issuers. Therefore, the bill includes in the new unified State volume limitation (discussed below) any portion of essential function bond proceeds in excess of $1 million that is used by nongovernmental persons. Subjecting this nongovernmental financing to the unified volume limitation provides a parity in its treatment with the treatment accorded other tax-exempt financing for nongovernmental persons.

Under present law, most bonds for nongovernmental persons are subject to one of three separate sets of volume limitations. The limitations apply to student loan bonds and most IDBs, to qualified mortgage bonds, and to qualified veterans' mortgage bonds. Substitution of a new unified volume limitation reflects the committee's decision to allow State and local governments flexibility in allocating bond volume among the different activities of nongovernmental persons qualifying for tax-exempt financing, while placing an effective overall limitation on the total nongovernmental bond volume.

Additionally, the committee believes that tax-exempt bonds for nongovernmental persons should be used exclusively for the activity for which such financing specifically has been approved. Under present law, in the case of IDBs and qualified veterans' mortgage bonds up to 10 percent of the nongovernmental bond proceeds may be used for nonqualifying activities without violating the tax-exempt status of these nongovernmental bonds for nongovernmental persons (the substantially all test). The committee believes that this leakage of bond proceeds is inconsistent with the principle that tax-exempt interest should be allowed only for bonds issued to finance qualifying activities. The bill provides, therefore, that no portion of the net bond proceeds may be used for activities other than those for the exempt purpose of the borrowing.

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[28] The committee bill permits issuance of tax-exempt nonessential function bonds that are exempt facility bonds (bonds for airports, docks and wharves, mass commuting facilities, water, sewage and solid waste disposal facilities, and multifamily residential rental projects), small-issue bonds, mortgage subsidy bonds, section 501(c)(3) organization bonds, student loan bonds, and qualified redevelopment bonds.

The committee believes further that certain nongovernmental facilities financed with nonessential function bonds require continuing governmental participation, and that other tax benefits arising from ownership of property should not accrue to nongovernmental persons also receiving the Federal subsidy provided by bond financing. Therefore, the bill provides that governmental ownership of airports, docks and wharves, mass commuting facilities, and water facilities is a requirement for tax-exempt financing. In adopting this rule, the committee believes that the present rule regarding governmental ownership under the IDB volume limitations does not ensure sufficient governmental participation on a continuing basis.[29]

Further, in the case of exempt-facility bonds for multifamily residential property and mortgage subsidy bonds, the committee believes it important that the bond proceeds be targeted better to provide rental housing for low-income families and to assist families who would not otherwise be likely to purchase a first home. The bill includes several new income and other targeting requirements and annual reporting requirements to accomplish this objective. To assist in future review of the use of the subsidies provided by these housing bonds, the bill requires, for example, an annual Treasury Department report on compliance with the new rules for multifamily residential rental property and retains the present-law sunset date (December 31, 1987) for qualified mortgage bonds.

Arbitrage restrictions

The committee is aware that the low borrowing cost obtained as a result of tax-exempt financing provides an opportunity to earn arbitrage profits unless transactions that may create such profits are restricted. The committee believes it important to limit the length of time that bond proceeds may be invested at unrestricted yields. Arbitrage is an inefficient substitute for additional bond volume and can be more costly to the Federal Government in terms of the foregone tax revenue than the additional bond volume necessary to produce the same amount of proceeds.

Additionally, arbitrage is a device for concealing the true cost of a bond-financed facility from the public, since in lieu of directly requesting additional bond authority (which the public might not approve), the issuer uses an indirect Federal Government subsidy (i.e, arbitrage profits) to underwrite a portion of the cost. Also, when allowable nonessential function bond volume is limited as under the bill, arbitrage profits may serve as a device through which projects are financed in excess of the allowable volume.

The committee believes that, like private borrowers, issuers of State and local government bonds should pay the borrowing costs associated with their bonds. Thus, under the bill, costs of issuance must be paid by issuers (or beneficiaries of the bonds) rather than being recovered through arbitrage profits as a Federal subsidy in addition to tax-exemption on the bond interest itself. The committee believes that this requirement will encourage issuers to scruti-

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[29] Governmental ownership is determined, therefore, by reference to general income tax concepts, rather than based upon an election to forego depreciation and investment credit as under present IDB volume limitation rules.

nize more closely the costs associated with bond issuance and, like the new unified volume limitation, will encourage better targeting of the Federal subsidy associated with tax-exempt bonds.

The committee also desires to place stringent controls on advance refunding of tax-exempt bonds. The ability to advance refund certain types of bonds under present law encourages tax-exempt borrowers to agree to covenants and other terms that other borrowers would reject. The ability of bond issuers to invest the proceeds of an advance refunding issue in Federal Government securities with yields equal to the yield of the refunding issue eliminates nearly all risk from undertaking the advance refunding. Advance refunding is inefficient in that it often results in many times the original volume of a single bond issue being outstanding simultaneously. Given the committee's desire to control the volume of tax-exempt obligations and to eliminate economic inefficiencies, the bill extends the present-law prohibition on advance refunding of IDBs and mortgage subsidy bonds to all nonessential function bonds, and restricts the circumstances under which essential function bonds may be refunded without prompt redemption of the refunded bonds.

Finally, the committee has learned that a few governments have issued bonds in order to purchase annuity contracts from insurance companies. The purpose of these transactions is to fund unfunded liabilities of public employee pension plans. In essence, these transactions produce arbitrage profits which would not be allowed if bond proceeds were invested directly by the issuing government. In view of the substantial amount of unfunded pension liabilities of State and local governments and because there has been no explicit Congressional decision to assume responsibility for those liabilities, the bill prohibits the issuance of bonds for such a purpose.

Explanation of Provisions

1. Overview

The bill reorganizes and amends the present-law rules governing tax-exemption for interest on obligations issued by or on behalf of qualified governmental units.[30] As part of this reorganization, the present-law rules contained in Code sections 103 and 103A are divided, by topic, into 11 Code sections (secs. 103 and 141-150). The committee intends that, to the extent not amended, all principles of present law apply under the reorganized provisions.[30a]

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[30] The term qualified governmental unit includes a State or a possession of the United States, any political subdivision of the foregoing, and the District of Columbia.

[30a] As under present law, interest on certain bonds authorized by non-Code provisions of law is tax-exempt when the authorization was enacted before January 1, 1984, and the bonds comply with all appropriate Code requirements. The appropriate Code requirements include all requirements that apply to Code bonds with respect to which the use of bond proceeds is comparable, including but not limited to the unified volume limitation, the arbitrage rules, the information reporting requirements, and, the restrictions on tax-exempt bonds for certain activities.

In general, bonds [31] the interest on which is tax-exempt may continue to be issued by or on behalf of[32] qualified governmental units to finance activities of the governments themselves without regard to (1) the volume limitation that applies to most bonds for activities conducted by nongovernmental persons[33] and (2) many of the other restrictions that apply to such other bonds. As discussed in 4., below, the new unified volume limitation applies to a portion of governmental bonds if more than $1 million of the proceeds is used by a nongovernmental person.

Thus, under the bill, States and local governments may continue to provide tax-exempt financing for general government operations as well as for the construction and operation of such facilities as schools, highways, government buildings, and governmentally owned and operated sewage, solid waste disposal, water, and electric facilities. Additionally, qualified governmental units may continue to issue short-term notes in anticipation of taxes and other revenues (TANs and RANs) to finance cash-flow shortfalls. Similarly, interest on most debt of qualified governmental units that does not involve formal issuance of bonds (e.g., installment purchase agreements and finance leases) is tax-exempt to the same extent that interest on bonds issued for the same purpose would be tax-exempt. Also, as under present law, interest paid by qualified governmental units other than pursuant to the exercise of their borrowing power is not tax-exempt (e.g., interest on State income tax refunds).

The determination of whether an entity is a qualified governmental unit continues to be made in the same manner as under present law. In general, therefore, an entity is a political subdivision (and therefore a qualified governmental unit) only if it has more than an insubstantial amount of one or more of the following governmental powers: the power to tax, the power of eminent domain, and the police power (in the law enforcement sense). For example, as governmental agencies, State owned and operated universities are governmental entities.[34]

Qualified governmental units also may continue to provide tax-exempt financing for certain nongovernmental activities. Bonds for activities of nongovernmental persons are referred to collectively as *nonessential function bonds*. All nonessential function bonds involve a use of bond proceeds (or of bond-financed property) by, or a loan of such proceeds to, a person other than a qualified governmental unit, which use or loan exceeds a specified portion of the proceeds. Unlike financing for general government operations, interest on nonessential function bonds is taxable unless a specific

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[31] Under these rules, the term bond also includes debt obligations of a qualified governmental unit that do not involve the formal issuance of a bond or note. For example, installment purchase agreements, finance leases, and most other evidences of debt issued pursuant to the borrowing power of a qualified governmental unit are treated as bonds.

[32] The bill continues the present-law rule allowing bonds to be issued either *by* or *on behalf of* qualified governmental units. *See*, e.g., Rev. Rul. 63-20, 1963-2 C.B. 397 and Rev. Proc. 82-26, 1982-1 C.B. 476.

[33] A nongovernmental person is any person other than a State or local governmental unit.

[34] The committee is aware that certain State universities also have received determination letters regarding their tax-exempt status under Code section 501(c)(3). The committee intends that, to the extent of a State-owned and -operated university's activities as a governmental unit, bonds for the State university will be treated as governmental bonds rather than as nonessential function bonds for activities of a section 501(c)(3) organization.

exception is provided in the Code. Tax-exempt nonessential function bonds, like bonds for governmental activities, may be issued by or on behalf of a qualified governmental unit.

Nonessential function bonds qualifying for tax-exemption include exempt-facility bonds, qualified mortgage bonds and qualified veterans' mortgage bonds,[35] small-issue bonds, section 501(c)(3) organization bonds, qualified student loan bonds, and qualified redevelopment bonds. Exempt-facility bonds are bonds issued to finance airports, docks and wharves, mass commuting facilities, water facilities (other than for irrigation), sewage disposal facilities, solid waste disposal facilities, and qualified multifamily residential rental projects. All facilities financed with such bonds must satisfy a public use requirement, discussed in 3., below.

2. Bonds for essential governmental functions

As under present law, the term governmental bond is not directly defined. Rather, bonds are treated as nonessential function bonds if more than a specified amount of proceeds is either (1) used in any trade or business of any person or persons other than a qualified governmental unit, or (2) used to make loans to such a person or persons.

***a.* Trade or business use**

General rules

A bond is a nonessential function bond if an amount equal to or exceeding the lesser of 10 percent or $10 million of bond proceeds is to be used directly or indirectly in any trade or business carried on by any person other than a qualified governmental unit. Under this rule, all activities of section 501(c)(3) organizations and the Federal Government and its agencies and instrumentalities, as well as all activities of any other nongovernmental person other than a natural person, are treated as trade or business activities. As under present law, the use of bond-financed property is treated as use of bond proceeds.[35a]

All bonds that would be IDBs under present law (applying the lesser of 10 percent or $10 million threshold) are nonessential function bonds because more than 10 percent (or $10 million) of the proceeds is used in a business of a nongovernmental person rather than for a governmental activity or facility. Because the security interest test of present law is deleted, however, bonds that satisfy the trade or business use test of the present-law IDB definition, but not the security interest test, also are nonessential function bonds.

The committee understands that in most (but not all) cases in which a nongovernmental person is considered to use proceeds of an issue, that person will make some form of direct or indirect payment to the governmental unit. Bonds may be nonessential func-

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[35] Certain bonds issued under a program of the State of Texas that has been continuously in existence for more than 30 years and pursuant to which bonds are issued to finance loans to veterans for the purchase of land also may continue to be issued under the bill, without regard to the March 15, 1987, sunset date of the tax-exemption for those bonds that is contained in present law. *See also*, footnote 60 for the application of the new unified volume limitation to these bonds.

[35a] Similarly, the use of bond proceeds is treated as use of any property financed with the proceeds.

tion bonds regardless of the form of direct or indirect payment made, or even if no payment (or a payment which does not reflect full value) is made. For example, bonds may be nonessential function bonds when payments are made to a qualified governmental unit by nongovernmental persons for the use of bond-financed facilities, but tax or other revenues (rather than the payments) are used to repay or secure repayment of the bonds (i.e., the payments by nongovernmental persons are not earmarked or otherwise specifically dedicated to repayment of the bonds). Similarly, bonds may be nonessential function bonds in certain cases where bond-financed improvements (e.g., land that has been cleared for development) are transferred to a nongovernmental person for a purchase price that does not reflect all costs incurred in preparing the land for nongovernmental use.

Applications of the concept of use

The general concept of use applicable under present law is retained under the bill. Thus, as under present law, a person may be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership, or (2) actual or beneficial use of the property pursuant to a lease, a management or incentive payment contract, or an arrangement such as a take-or-pay or other type of output contract.

Under the concept of use, bond proceeds and bond-financed facilities that are available for use by members of the general public on the same basis are not treated as being used in a nongovernmental activity. If any nongovernmental person or persons use bond-financed property other than as a member of the general public, however, the use of such property is considered to be use of the proceeds of the issue; the issue is not an issue of bonds for an essential governmental function if the nongovernmental use equals or exceeds the 10 percent or $10 million threshold for a nonessential function bond. Use by all nongovernmental persons that use bond-financed property on a basis unlike that of the general public is aggregated in determining whether that threshold is exceeded.

In the case of most nonessential function bonds, the determination of the nongovernmental user of the facilities will be clear, since one such person or a limited group of such persons will use most or all of the facility subject to an identifiable lease, contract, or other arrangement that differentiates that person's use of the facility from the use by the public at large. In other cases, a facility that is nominally governmentally used, may in fact be used in whole or in part by a nongovernmental person or persons in such a manner as to render bonds for the facility nonessential function bonds. The committee intends that the determination of whether bonds for such facilities are nonessential function bonds is be made on a case-by-case basis, under the principles of the trade or business use test of present law, taking into account all facts and circumstances regarding use of the property.[36]

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[36] The committee is aware that, under present law, limited use of facilities by nongovernmental persons on a basis unlike that of the general public is disregarded in certain cases. *See e.g.*, Treas. Reg. sec. 1.103-7(c), Examples (6) and (11), Rev. Proc. 82-14, 1982-1 C.B. 459, and Rev. Proc. 82-15, 1982-1 C.B. 460. *See also*, Treas. Reg. sec. 1.103-7(b)(3) and Rev. Rul. 77-352, 1977-2 C.B. 34.

For example, bonds used to finance a highway or a municipal park that is not available to any nongovernmental person other than as a member of the general public are essential function bonds. On the other hand, bonds used to finance a typical airport are nonessential function bonds, because the airlines operating at the airport use the facilities on a basis different from that of other members of the public. Bonds to finance mass commuting facilities operated by a nongovernmental person pursuant to a management contract (other than a short-term contract) likewise are nonessential function bonds because the nongovernmental operator uses the facilities on a basis different from that on which members of the general public use the facilities.

Bonds for a government building (e.g., a school building that is used as part of a local public school system) are essential function bonds. Interest on such bonds does not become taxable as a result of availability and use of the school building by such nonprofit community groups as girl scouts, boy scouts, or community recreational sports teams during the evening hours. Use by such community groups must be incidental to the governmental function of the building and the building must be available for use on an equal basis by all such groups for the nongovernmental use involved to be disregarded. Similarly, the fact that the groups are charged a *de minimis* fee to cover costs of custodial services provided in connection with the use is disregarded provided there are no special arrangements with any one group for use other than as a member of the general public.

Bonds for convention centers, auditoriums, and sports facilities similarly are classified as essential function bonds or as taxable nonessential function bonds based on the use of the facilities. Bonds for a governmentally owned and operated convention center that is available for rental to all members of the public on an equal basis are essential function bonds if no one organization (or limited group of organizations) has an extended right to use the facilities. (*See e.g.*, Treas. Reg. sec. 1.103-7(c), Example (11).) On the other hand, bonds for a sports facility that is used by a professional football or other sports team for its at-home games typically are taxable nonessential function bonds even though the facility also is used by other nongovernmental persons during periods when it is not required by the football team. (*See*, e.g., Treas. Reg. sec. 1.103-7(c), Example (12).)

The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property. As under present law, however, the proceeds of an issue generally are not treated as used in any trade or business of a nongovernmental person when the proceeds are used to pay for services rendered to the government or to defray other liabilities of a governmental unit arising from general government operations. For example, bond proceeds used to purchase a computer to be owned and used by the purchasing governmental unit are not treated as used in the computer company's business. Likewise, bond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government employees' salaries, or to pay legal judgments against a governmental unit, are not treated as used in the busi-

ness of the payee. This is to be contrasted with the indirect nongovernmental use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's business with a service (e.g., electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (e.g., a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public.

Many States provide for the creation of tax or utility districts that are themselves qualified governmental units to provide essential governmental functions to an area within a larger such governmental unit. During an initial development period, the land in such a district may be owned by a single developer (e.g., a redevelopment agency), or a limited group of developers, who are proceeding with all reasonable speed to develop and sell the land to members of the general public for residential or commercial use. The committee intends that bond proceeds used in such situations to finance facilities for essential governmental functions such as extensions of municipal water systems; street paving, curbing (including storm water collection), and sidewalk and street-light installation; and sewage disposal generally not be treated as used in the trade or business of the developers. Rather the tax status of the bonds generally will be determined by reference to the ultimate (i.e., after the initial development period) use of the facilities.

Such bonds may be treated as essential function (i.e., governmental) bonds, or as exempt-facility bonds, provided that (1) the facilities are designed to serve members of the general public in the governmental unit on an equal basis; (2) ultimate ownership and operation of the facilities is with persons other than the developers (e.g., the governmental unit); and (3) development of the district for sale and occupation by the general public proceeds with reasonable speed. Failure of the developers to complete the district for use and occupancy by the general public, or financing of any facilities to be used by one or a limited group of persons, results in interest on the bonds being taxable from the date of issue. *See also*, the discussion of the private loan bond restriction, below, for rules regarding the treatment as "excluded loans" of mandatory taxes or other assessments of general application that may be levied in connection with certain types of improvements.

Use on the same basis by all members of the general public may be determined by reference to reasonable availability for use, rather than actual use, in certain cases. For example, bonds for a governmentally owned and operated hospital whose services are available on the same basis to all members of the public are essential function bonds, notwithstanding the fact that only persons in need of medical services routinely use the hospital facilities. Hospital facilities that are operated (other than on a short-term basis) by persons such as a private physician's service corporation or other nongovernmental person pursuant to a management or service contract are nongovernmental facilities. Such facilities are nongovernmental, even though they serve all patients of the hospital, because the facilities are used by the manager or independent contractor service provider on a basis different from that which the general

public uses the hospital. *But see,* Rev. Proc. 82-14, *supra.*, and Rev. Proc. 82-15, *supra.*

Similarly, bonds for a governmentally owned and operated electric utility that serves a substantial portion of the members of the general public on the same basis are essential function bonds. The fact that some customers of the utility may purchase more electric power than others or that rates charged to customers who purchase electric power in bulk may reflect volume discounts does not necessarily indicate that the output of the facility is not made available to members of the public on the same basis, as long as such transactions in substance do not approximate an output contract or a take-or-pay contract or otherwise constitute use of the bond proceeds of the issue by such customer.

Bonds may be essential function bonds even though one industrial customer, or a limited group of customers, indirectly receive the benefit of an amount of bond proceeds in excess of an amount equal to the lesser of 10 percent or $10 million as long as the benefit it receives is not other than as a member of the general public. Consumption of electric energy pursuant to a contract or other arrangement unlike the arrangement available to all members of the general public, however, would be treated as nongovernmental use. For example, if one or more nongovernmental persons were so entitled to an amount of electric energy that resulted in an aggregate use of bond proceeds equal to or exceeding the lesser of 10 percent or $10 million, the bonds would be nonessential function bonds. Similarly, bonds for a facility to be used by one or a limited number of nongovernmental persons would be nonessential function bonds since the facility would not qualify as serving the general public.

In the case of a State owned and operated university, dormitories for students are facilities used by the university despite the nongovernmental use associated with occupancy of the dormitory rooms by students for a semester or academic year. (This is to be contrasted with the operation of student or faculty apartments of a type available on the commercial market, an activity like the ownership and operation of for-profit residential rental property.) Likewise, the operation of a faculty research facility at such a university may be an essential governmental function when such a facility is owned and operated by the university, as may be the operation of a student dining hall. Bonds for a dining hall that is operated by a nongovernmental person pursuant to a management contract are nonessential function bonds if the management contract is not on a short-term basis.

The committee is aware that the conduct of basic research is an integral function of universities, and that State universities may enter into cooperative agreements with nongovernmental persons for the conduct of such basic research. The findings in connection with research conducted at these facilities are disseminated to the general public through various scientific and technical journals. Title to any patent incidentally resulting from the research conducted pursuant to the cooperative arrangement lies exclusively with the educational institution, and not with any nongovernmental person. Similarly, no nongovernmental participant in the cooperative research arrangement is entitled to preferential use of any

product of the research (including any patent). The committee intends that use of bond-financed property by nongovernmental persons pursuant to such a cooperative research arrangement is not to be considered when determining the degree of nongovernmental use of the property provided that the nongovernmental use does not involve the commercial exploitation of the research activities or the conduct of a separate, trade or business (e.g., an unrelated trade or business activity under sec. 511). The committee further understands that section 501(c)(3) universities may enter into similar cooperative arrangements; activities of such section 501(c)(3) organizations are treated as related to their educational function to the same extent that like activities of a State educational institution are treated as governmental activities.

b. Loans to nongovernmental persons

A bond is a nonessential function bond if an amount equal to or exceeding the lesser of 5 percent or $5 million of bond proceeds is to be used (directly or indirectly) to make or finance loans to any person other than a qualified governmental unit. As under the present law private loan bond restriction, a loan is present regardless of whether bond proceeds are transferred directly to a nongovernmental person or whether a transaction involves an indirect transfer (or deemed transfer) that is in substance a loan. Interest on bonds that are nonessential function bonds as a result of loans to nongovernmental persons may qualify for tax-exemption if the loans are made for a nonessential function otherwise satisfying the Code requirements for tax-exempt financing.

An exception to this restriction is provided (as under present law) for the financing technique accomplished with obligations known as tax-assessment bonds. Indirect loans made to enable a borrower to finance a tax or governmental assessment of general application for an essential governmental function are disregarded in determining whether interest on an issue is tax-exempt. Under this exception, the deemed loans arising from mandatory taxes or other assessments of general application for specific essential governmental functions (as opposed to installment payments of property or other taxes generally) that a qualified governmental unit permits its residents to pay over a period of years, are disregarded in determining if interest on the bonds is tax-exempt. Rather, the determination of whether an essential governmental function is being financed is made based upon the use of the facilities or services being financed or the making of loans that are not disregarded under the exception for tax assessment bonds. Examples of the types of specific activities that may be treated as essential governmental functions under this exception include street paving and street-light installation, sewage treatment and disposal, and municipal water facilities.

The committee understands that the method of assessing residents for these improvements varies from State to State. Taxes or other mandatory assessments with respect to the improvements serving an essential governmental function may be levied on a property frontage basis or may be levied on an *ad valorem* basis. The committee intends that deemed loans for these purposes be disregarded in determining the tax status of bonds whether the taxes

or other assessments are based on a property frontage basis, an *ad valorem* basis, or any other comparable method that results in equivalent mandatory assessments to all residents benefiting from the improvements.

The committee also wishes to clarify the application of this rule to taxes or other assessments levied on property used in a trade or business.[37] It is the committee's intention that this exception apply when the assessed property is used in a trade or business as well as when the assessed property is used for nonbusiness purposes. In such cases, the exception applies only if the tax or other assessment is mandatory and for an essential governmental function and only if both business and nonbusiness property are eligible to make deferred payments of such tax or assessment on an equal basis. As in the case of loans exclusively to persons not engaged in a trade or business, the character of the improvement being financed (i.e., the use of the bond proceeds) rather than the presence of the indirect loan determines the tax status of the bonds. For example, bonds for a governmentally owned and operated sewage disposal system may be essential function bonds despite the fact that both individual and business residents of the governmental unit who use the system are permitted to pay taxes or assessments levied in connection with its installation in installments, while such bonds for a similar privately managed sewage disposal system serving the general public could be nonessential function-exempt-facility bonds.

As stated above, whether the private loan bond restriction is violated depends on the substance of the transaction rather than its form. In addition to loans evidenced by formal promises to pay, installment payment agreements, certain leases, and other arrangements (e.g., take-or-pay and output contracts) under which a qualified governmental unit permits nongovernmental persons to defer payments either directly or indirectly may constitute a loan for purposes of the private loan bond restriction. For example, if a qualified governmental unit transfers property to a nongovernmental person in exchange for a right to all or any portion of the income from the property, the transfer may involve a loan.

3. Exceptions for certain nonessential function bonds

a. Exempt-facility bonds

In general

Interest on certain exempt-facility bonds[38] issued by or on behalf of qualified governmental units may be tax-exempt even though the percentage tests for trade or business use by, or loans to, nongovernmental persons are exceeded.[39] As discussed above, exempt facilities eligible for tax-exempt financing include airports, docks and wharves, mass commuting facilities, facilities for the furnish-

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[37] *See also*, the discussion of use in a trade or business, 2.a., above, for rules regarding the availability of tax-exempt financing for such improvements installed during an initial development period when all or a majority of the property in an area may be owned by one or a limited group of developers.

[38] Bonds for these activities are classified as exempt-activity IDBs under present law.

[39] Bonds issued as part of the State of Texas Veterans' Land Bond Program also may continue to be issued under the bill, without regard to the presently scheduled March 15, 1987, termination of authority to issue those bonds.

ing of water (other than for irrigation), sewage disposal facilities, solid waste disposal facilities, and qualified multifamily residential rental projects.

In general, an issue qualifies as an issue of exempt-facility bonds only if the bond-financed property is owned for Federal income tax purposes by a qualified governmental unit.[40] Exceptions are provided permitting nongovernmental ownership of bond-financed multifamily residential rental projects and sewage and solid waste disposal facilities. In addition, an issue is an issue of exempt-facility bonds only if all net proceeds (i.e., all proceeds other than costs of issuance and amounts invested as part of a reasonably required reserve or replacement fund) are expended for the exempt purpose of the borrowing. Expenditures for property that under present law is functionally related and subordinate to the exempt facility, but that is not a part of the facility, are not treated as expenditures for the exempt purpose of the borrowing. All exempt facilities must satisfy the public use requirements that apply to exempt-activity IDBs under present law. (*See*, e.g., Treas. Reg. sec. 1.103-8(a)(2).) Finally, except in the case of certain airport and dock and wharf facilities, all exempt-facility bonds are subject to a new unified State volume limitation for bonds the proceeds of which are to be used by nongovernmental persons.

Airports

Exempt-facility bonds may be used to finance airports, defined as ground facilities directly related and essential to the transportation by air of passengers and cargo.[41] Under this exception, tax-exempt financing is permitted for facilities such as runways and taxiways, air traffic control towers, radar installations, certain airport terminal facilities, facilities for crash/fire/rescue operations, airport hangars, maintenance facilities that must be located at the airport site because of their direct connection with air transportation, public parking facilities that are directly related and essential to transportation by air of passengers and cargo, and roadways and related improvements providing immediate access to other airport facilities that qualify for tax-exempt financing. Additionally, land set aside for noise abatement purposes and future qualified airport use qualifies as part of an airport as long as no other significant use is made of the land by a nongovernmental person before actual airport use.

Offices for airport and airline employees constitute part of an airport when the offices are located in airport terminals or other airport facilities (e.g., hangars) qualifying for exempt-facility bond financing, but only if the space occupied by and the financing costs attributable to those offices is *de minimis* in relation to the cost of the building in which they are located. To qualify as part of an airport, the offices must be limited in size to the direct requirements of servicing the actual movement of passengers and cargo at the airport, and the functions performed therein must be so integrally

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[40] *See* 8., below, for a discussion of the governmental ownership requirement.

[41] In general, exempt-facility bonds for airports are not subject to the unified State volume limitation. *See* 4., below, for rules under which bond proceeds used for cargo-handling facilities are subject to that limitation.

related to the transportation function of the airport that they could not be conducted at another site. For example, an office for pilots to prepare flight plans qualifies as part of an airport, while a regional office for an airline or an airline reservation office does not qualify because the function performed in these latter offices can be conducted from a site apart from the airport.

Manufacturing facilities do not qualify as airport facilities. Exempt-facility bond financing also may not be used for airport hotels, in-flight kitchen facilities, other airport food or beverage preparation and service facilities (e.g., restaurants and cocktail lounges), gift shops, bookstores, and other retail or wholesale facilities (e.g., offices and space for car rental agencies) that serve the general public or the airlines operating at the airport.

The committee is aware that many airport terminal and other facilities may be used in part for activities qualifying for exempt-facility bond financing and in part for other purposes. The committee intends that in determining the portion of costs of such mixed-use airport facilities to be financed with exempt-facility bonds, the cost of nonqualified facilities include only the structural components required for the nonqualified portion of the facility (e.g., interior walls, partitions, ceilings, and special enclosures) and the interior furnishings of that facility (e.g., additional plumbing, electrical, and decorating costs). The costs of the general components of the terminal or other airport facility, such as land, structural supports, and exterior walls, are not to be allocated to property ineligible for exempt-facility bond financing to the extent that these general components are required for the remaining portion of the airport (assuming the nonqualified facility had not been built and assuming the qualified facility could be correspondingly smaller).

Docks and wharves

Docks and wharves eligible for exempt-facility bond financing are defined as facilities directly related and essential to the transportation of passengers and cargo by water.[42] Only the following dock and wharf facilities are eligible for financing with exempt-facility bonds: structures alongside which a vessel docks; facilities used in the handling and receiving of cargo (e.g., cranes, forklifts, and conveyors and other equipment used in the loading and unloading of cargo); passenger areas; parking areas (including vacant areas for containers); road and rail interchanges providing direct access to other dock and wharf facilities financed with exempt-facility bonds; ship repair and maintenance facilities that must be located at the port site because of their direct connection with water transportation; and land set aside for environmental purposes or future use provided no other significant use is made of the land by a nongovernmental person before qualified dock and wharf use. Additionally, costs of harbor and channel dredging and slack water harbor facilities may be eligible for exempt-facility bond financing under the exception for docks and wharves.

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[42] Bonds for dock and wharf facilities generally are not subject to the new unified State volume limitation. *See* 4., below, for rules under which storage facilities eligible for exempt-facility bond financing are subject to this limitation.

Facilities used for the storage of cargo immediately before or immediately following shipment also may be financed with exempt-facility bonds. (Storage facilities other than those involved in the immediate shipment of cargo are not eligible for exempt-facility bond financing.) Storage facilities eligible for exempt-facility bond financing include (1) facilities, such as tanks and elevators, that hold fungible commodities immediately prior to or subsequent to shipment,[43] and (2) those structures, such as transit sheds, in which cargo is held for short periods of time, generally less than 30 days, immediately prior to or subsequent to shipment by water. In the case of facilities described in (1) and (2), bond financing is available only if no additional user fees (beyond standard shipping costs) are regularly charged with respect to the storage facility, either directly or indirectly.

Docks and wharves also include offices for the use of governmental employees operating a port facility. They do not include offices used by employees of nongovernmental persons whose duties are not directly related and essential to the loading, unloading, or movement of vessels, cargo, and passengers whose duties otherwise could be performed at a location other than the immediate port site. Offices for nongovernmental persons whose duties are directly related and essential to transportation by water of cargo and passengers qualify for exempt-facility bond financing only if the space occupied by and costs of the offices is *de minimis* in relation to other space in the same or related buildings that also is used directly for that transportation function. Manufacturing facilities are not considered to be dock and wharf facilities. Additionally, no portion of exempt-facility bonds for docks and wharf facilities may be used to provide lodging facilities, food and beverage preparation and service facilities, gift shops, or other retail or wholesale service facilities.

The committee understands that certain facilities not eligible for exempt-facility bond financing may be located at port sites, and that in certain cases, facilities may be used in part for activities that qualify for such financing and in part for nonqualified activities. The committee intends that allocation rules similar to those used for airport facilities will apply in determining what costs of a mixed-use facility may be financed with exempt-facility bonds.

Mass commuting facilities

Exempt-facility bonds may be issued to finance mass commuting facilities that serve the general public as commuters on a daily basis. As is true of qualified airport and dock and wharf facilities, mass commuting facilities eligible for exempt-facility bond financing include only that property directly related and essential to the transportation function involved. For example, exempt-facility bonds may be issued to finance terminals and other real property facilities, machinery, equipment, and furniture directly related and essential to the provision of bus, subway, rail, and ferry commuter service. (Mass commuting vehicles, like airplanes and ships in the

[43] Transit sheds, tanks, elevators, and other facilities having storage capacity in excess of the volume regularly shipped during a period not exceeding 30 days are longer-term storage facilities and are not eligible for exempt-facility bond financing.

case of airports and ports, are not eligible for exempt-facility bond financing.)

Mass commuting facilities also include offices for the use of governmental employees operating the mass commuting system. They do not include offices used by employees of nongovernmental persons whose duties are not directly related and essential to the daily commuting by the general public. Additionally, such nongovernmental office space is eligible for exempt facility bond financing only if the space occupied by and costs of the offices is *de minimis* in relation to other space in the same or related buildings that is used for the actual transportation function of the mass commuting facility. Additionally, no portion of exempt-facility bonds for mass commuting facilities may be used to provide lodging facilities, food and beverage preparation and service facilities, gift shops, or other retail or wholesale service facilities, or for special access connections for a single nongovernmental person (e.g., an entrance to a subway system directly from a retail store or office building).

The committee understands that certain facilities not qualified for exempt-facility bond financing may be located in otherwise qualified mass commuting facilities. The committee intends that allocation rules similar to those used for airport facilities will apply in determining what costs of such a mixed-use facility may be financed with exempt-facility bonds.

Certain facilities for the furnishing of water

Exempt-facility bonds may be issued to finance facilities for the furnishing of water to the general public under rules similar to those applicable under present law. Water facilities to be used to provide irrigation may not be financed with exempt-facility bonds. As is true of the other exempt facilities, discussed above, only that property that is directly related and essential to the exempt purpose of the borrowing is qualified for exempt-facility bond financing. Therefore, property that is only functionally related and subordinate to the exempt facility (e.g., general corporate offices of an operator of the facility) does not qualify for tax-exempt financing.

The general public encompasses all water users, including electric utility, industrial, agricultural (other than for irrigation), or commercial users. Furthermore, a qualifying facility must be operated by a governmental unit or, alternatively, the rates for the furnishing or sale of the water must be established or approved by a governmental unit.

Sewage disposal facilities

Exempt-facility bonds may be issued to finance sewage disposal facilities, defined generally as under present law except that only property comprising the sewage disposal facility itself (e.g., collection pipes and treatment plants) may be financed with tax-exempt bonds. The administrative offices of a nongovernmental sewage disposal authority do not qualify for exempt-facility bond financing, whether the offices are located in the same structure as the actual disposal facility or elsewhere. On the other hand, offices located within a waste-treatment facility that are directly related and essential to its day-to-day operation would qualify provided the

amount of space occupied by and the costs of the offices are *de minimis* in relation to the facility as a whole.

Solid waste disposal facilities

Exempt-facility bonds may be issued to finance solid waste disposal facilities, defined generally as under present law except only property that is directly related and essential to the disposal of solid waste may be financed with exempt facility bonds. For example, as under the rules for sewage disposal facilities, nongovernmental offices located within the waste-disposal facility that are essential to its day-by-operation may be financed with exempt-facility bonds provided the space occupied by and the costs of the offices are *de minimis* in relation to the overall facility. Offices not satisfying this requirement (e.g., general administrative offices) may not be financed with exempt-facility bonds, whether the offices occupy a portion of the waste disposal facility or are located in a separate building. As under the present-law rules, tax-exempt financing may be provided for the processing of solid waste or heat into usable form, but not for further processing that converts the materials or heat into other products (e.g., for electric generators). (*See*, Temp. Treas. Reg. sec. 17.1.)

Qualified multifamily residential rental projects

Multifamily residential rental projects, defined in a manner similar to present law, are an eligible exempt facility. This property is eligible for tax-exempt financing only if a specified number of housing units in the project are occupied by individuals having low or moderate incomes (determined on a continuing basis)[44] and only if the property remains as rental property for a prescribed qualified project period. In addition, the bill requires operators of these projects to certify annually that the project is in compliance with the set-aside requirement applicable to the project, and requires the Treasury Department to make annual reports to the Committee on Ways and Means and the Committee on Finance on nationwide compliance with Code requirements.

Property comprising the exempt facility

A qualified residential rental project includes a building containing residential rental units and other property that is directly related and essential to the function of providing residential rental units. As under present law, a project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing.

Facilities directly related and essential to the housing function of the project and thereby comprising qualified residential rental property include such tenant amenities as swimming pools, other recreational facilities[45] and parking areas. Additionally, trash dis-

[44] This requirement is referred to as the set-aside requirement.

[45] Tax-exempt financing is prohibited generally for any recreational facilities that comprise a health club.

posal facilities and common heating and cooling plants are included, as are housing units occupied by resident managers or maintenance personnel. (*See generally*, Treas. Reg. sec. 1.103-8(b)(4)(iii).)

Multifamily residential rental property is eligible for tax-exempt financing only if the housing units are used on other than a transient basis. In addition, each residential rental unit must include separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Hotels, dormitories, hospitals, nursing homes, and trailer parks are not qualified residential rental property. (*See*, e.g., Treas. Reg. sec. 1.103-8(b)(4)(i).)

As under present law, residential rental property may qualify as an exempt facility even though a portion of the building in which the residential rental units are located is used for a commercial use. Unlike present law where up to 10 percent of the proceeds may be so used, no portion of exempt-facility bond proceeds may be used to finance property not actually used for the residential rental property. The committee intends that the costs of such a mixed-use facility may be allocated according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the residential rental units and nonqualifying property. (*See, e.g.*, Prop. Treas. Reg. 1.103-(8)(b).)

Required set-aside for low- and moderate-income tenants

The bill amends the present set-aside requirements to permit issuers of exempt-facility bonds for multifamily residential rental property to elect to receive financing for projects if either of two set-aside requirements is satisfied. This election must be made no later than the earlier of the date on which the qualified project period begins or, if later, the date on which the bonds are issued. Once made, this election is irrevocable.

Residential rental projects may qualify for tax-exempt financing if—

(1) 25 percent or more of the units are occupied by tenants having incomes of 80 percent or less of the area median income, or

(2) 20 percent or more of the units are occupied by tenants having incomes of 70 percent or less of the area median income.

Unlike under present law, there are no special rules for multifamily residential rental projects located in targeted areas.

As under present law, the set-aside requirement must be satisfied continuously during a qualified project period. Unlike present law, however, the determination of whether a tenant qualifies as having low- or moderate-income is made on a continuing basis, rather than only on the date the tenant initially occupies the unit. The increase in a tenant's income may, therefore, result in a unit ceasing to qualify as occupied by a low- or moderate-income person. However, a qualified low- or moderate-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this rule, if a family qualified as having low- or moderate-income when initially occupying a housing unit, that family will be treated as continuing to have such an income as long as its family income does not increase to a level more than 20 percent in excess of the maximum income qualifying as low- or moderate-income for a family of its size under the standard applicable to the project. However, if the tenant's family income increases to a

level more than 20 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant) that tenant may no longer be counted in determining whether the project satisfies the set-aside requirement.

The bill also clarifies that present law requires that adjustments for family size be made in determining the area median incomes used to qualify tenants as having low or moderate income. In general, these adjustments are the same as the adjustments presently made under section 8 of the United States Housing Act of 1937. Thus, if a project qualifies by setting aside 25 percent of the units for tenants having incomes of 80 percent or less of area median income, a family of four generally will be treated as having a low- or moderate-income if the family has an income of 80 percent or less of the area median income; a family of three having an income of 72 percent or less generally will qualify; a family of two having an income of 64 percent or less generally will qualify; and, a single individual having an income of 56 percent or less generally will qualify. The committee intends that similar 10-percent reductions be made to reflect family size if the option of setting aside 20 percent of the units for tenants having incomes of 70 percent or less of area median income is elected. The committee is aware that, in certain cases, continuing the present-law use of section 8 guidelines will result in qualifying incomes below the amounts reflected by these percentages because of dollar ceilings that are applied under the section 8 program.

Qualified project period

Bond-financed residential rental projects must remain as rental property and must satisfy the set-aside requirements, described above, throughout a prescribed qualified project period. The bill redefines the qualified project period as the period beginning on the date on which at least 10 percent of the units in the project are first occupied (or the date on which the exempt-facility bonds are issued) and ending on the latest of (1) the date that is 15 years after the date on which at least 50 percent of the units are first occupied; (2) the maturity date of the bond used to finance the project that have the latest maturity date; or (3) the date on which any assistance provided with respect to the project under section 8 of the Housing Act of 1937 terminates.

Annual certification of compliance

Under the bill, operators of bond-financed multifamily residential rental projects must certify compliance with the low- and moderate-income set-aside requirements applicable to these exempt facilities to the Treasury Department on an annual basis. The committee intends that the Treasury Department may require in the certification such additional data as it deems necessary to monitor compliance with this requirement. In general, the required certification will be made by operators of projects as agents of the project owners; however, under the bill, project owners are liable for a new penalty as a result of any failure on the part of the operators to make complete and timely reports. Failure to make required reports does not in itself affect the tax status of bond interest.

Correction of and penalty for noncompliance with set-aside, rental use, and annual certification requirements

As under present law, owners and operators of bond-financed residential rental property must correct any post-issuance noncompliance with the set-aside requirement within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. The committee does not intend, however, that tenants be evicted to return a project to compliance. Rather, the committee intends that each residential rental unit that becomes vacant while a project is not in compliance with the set-aside requirement must be rented to a tenant having a low or moderate income before any units in the project are rented to tenants not so qualifying until the project again is in compliance. (This rule also applies if the rental of the unit to a nonqualifying tenant would itself cause the set-aside to be violated). In general, therefore, the event that gives rise to penalties for noncompliance will be rental of a unit to other than a low- or moderate-income tenant (on other than a temporary basis) during any period when the project does not comply with the set-aside requirement (or would not qualify as a result of that rental).

The bill provides two penalties for failure to comply with the set-aside and rental use requirements during the qualified project period. First, as under present law, interest on the bonds used to finance the project becomes taxable, retroactive to the date of their issuance. In addition to this present-law rule, failure to correct any noncompliance with the set-aside requirement after it is discovered or reasonably should have been discovered, or termination of use as rental property, results in all interest on bond-financed loans being nondeductible, effective from the first day of the taxable year in which the noncompliance occurred.[46] If the noncompliance arises solely because of failure to satisfy the set-aside requirement, interest incurred on bond financed loans after a project is again in compliance with that requirement is deductible. Interest on the bonds, however, remains taxable (as under present law).

The bill provides a special penalty for failure to make the required annual certification of compliance with the low- and moderate-income set-aside requirement. This penalty is equal to $100 for each failure to comply and is in lieu of loss of tax-exemption on the bonds or denial of deductions for interest on bond-financed loans. For purposes of applying the penalty, a separate failure to comply occurs each day after the due date that a report is not filed. Likewise, reports with respect to each project owned by one person or a group of related persons, are separate reports, with any penalty being imposed independently for each such project's required report.

Annual report to Congress by Treasury Department

The Treasury Department is required to make an annual report to the Committee on Ways and Means and the Committee on Finance on compliance with the set-aside requirement with respect to

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[46] For a more complete discussion of new rules governing deductibility of interest on bond-financed loans, *see* the discussion in 7., below, regarding changes in use of property with respect to which tax-exempt financing is provided.

bond-financed residential rental projects. The committee intends that this annual report also include statistical data on the income distribution of tenants in qualified residential rental projects, and other relevant information such as whether below-market rents are provided to low- and moderate-income tenants, the relative percentages of family income paid in rent by low- and moderate-income tenants as opposed to tenants not qualifying as such, and information regarding the age of bond-financed projects.

b. Mortgage subsidy bonds and mortgage credit certificates

Tax-exemption for interest on qualified veterans' mortgage bonds and qualified mortgage bonds is continued under the bill, subject to certain new eligibility and targeting requirements and rules on use of bond proceeds. Additionally, the option to exchange authority to issue qualified mortgage bonds for authority to issue mortgage credit certificates is retained. As under present law, authority to issue qualified mortgage bonds and mortgage credit certificates will expire after December 31, 1987. Also as under present law, mortgage loans may not be financed with tax-exempt bonds except as specifically provided in this section, because of the private loan bond restriction.[47]

Qualified veterans' mortgage bonds

States presently authorized to issue qualified veterans' mortgage bonds are permitted to continue issuing such bonds, generally subject to the eligibility and other requirements contained in present law.[48] As is true of all nonessential function bonds for which tax-exemption is provided, all net proceeds (all proceeds other than costs of issuance and amounts invested in a reasonably required reserve or replacement fund) of each issue of qualified veterans' mortgage bonds must be used for the purpose of the issue (i.e., to make mortgage loans to qualified veterans for the purchase of owner-occupied residences).

Qualified mortgage bonds

The bill continues the exception permitting issuance of qualified mortgage bonds, subject to several amendments to the borrower-eligibility and targeting requirements applicable to the bonds.[49] In general, the amended borrower-eligibility and targeting requirements are similar to those requirements as they were in effect before enactment of the Tax Equity and Fiscal Responsibility Act of 1982.[50]

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[47] Mortgage loans do not qualify as excluded loans eligible for the tax-assessment bond exception.

[48] Qualified veterans' mortgage bonds are subject to the new unified State volume limitation for bonds issued for nongovernmental persons, discussed in 4., below, in lieu of the present volume limitations imposed on their issuance.

[49] Qualified mortgage bonds are subject to the new unified State volume limitation for bonds for nongovernmental persons, discussed in 4., below, in lieu of the present-law volume limitations imposed on their issuance.

[50] The new income limits included in the bill are similar to income limits passed by the House of Representatives in 1980.

Requirement that all proceeds be used to finance owner-occupied residences for first-time homebuyers

Under the bill, an issue qualifies as a qualified mortgage issue only if all net proceeds of the issue (i.e., all proceeds other than proceeds used for issuance costs and amounts invested in a reasonably required reserve or replacement fund) are used to finance residences for mortgagors who had no present ownership interest in their principal residences during the three-year period before the mortgage is executed (i.e., to first-time homebuyers). As under present law, proceeds used to provide qualified home improvement or qualified rehabilitation loans[51] are not taken into account for purposes of this rule. In targeted areas, at least 50 percent of bond proceeds are required to be used for loans to such first-time homebuyers. Compliance with this reduced requirement for targeted area loans is on an issue-by-issue basis. A mortgagor's interest in the residence being financed is not taken into account for purposes of the first-time homebuyer requirement.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence.

Income limitations

The bill imposes income limitations for recipients of qualified mortgage bond financing. Under these limitations, qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent of the greater of (1) the median family income for the area in which the residence is located, or (2) the Statewide median income. Additionally, 50 percent of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors whose family income does not exceed 90 percent of the greater of the median family income for the area or the State. Family income of mortgagors (as well as median family income) is to be determined under Treasury Department regulations which take into account the regulations and procedures under section 8 of the United States Housing Act of 1937. Unlike under the rules regarding qualified residential rental projects, no adjustments for family size are made under these income limitations.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent of the greater of (1) the median family income for the area in which the residence is located, or (2) the Statewide median income. The remaining one-third of the net proceeds of an issue may be used to provide mortgage loans without regard to income limitations. A targeted area is defined (as under present law) as (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or

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[51] The bill conforms the definition of qualified rehabilitation for this purpose to amendments made to the rules regarding the rehabilitation credit, except the amount required to be spent for rehabilitation is not changed.

less of the Statewide median family income, or (2) an area of chronic economic distress satisfying criteria prescribed by the Secretary of the Treasury and the Secretary of Housing and Urban Development. This definition of targeted area is the same as the definition used under the purchase price limitations applicable to residences financed with these bonds.

Mortgage credit certificates

Qualified governmental units may continue to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). Conforming amendments are made to the MCC provisions to reflect the amendments to the qualified mortgage bond provisions, including the amendments relating to purchase price and income limitations.

Annual policy statement requirement

The bill repeals the requirement that issuers of qualified mortgage bonds and mortgage credit certificates annually publish and submit to the Treasury Department statements detailing their policies governing issuance of such bonds and credits. The present-law information reporting requirements are retained. (*See* 9., below.)

c. Small-issue bonds

The bill repeals the scheduled termination dates in 1986 and 1988 for small-issue bonds. Therefore, these bonds may continue to be issued to finance depreciable property and land, including such land (and *de minimis* amounts of equipment acquired in connection with the land) financed under the first-time farmer exception. Except for certain amendments applicable to all nonessential function bonds (e.g., the requirement that all net proceeds of an issue be used for the exempt purpose of the borrowing), all present-law restrictions applicable to these bonds generally continue to apply under the bill. Additionally, if the requirements for small-issue bonds are satisfied, certain activities that formerly could be financed both with exempt-activity IDBs and small-issue IDBs (e.g., convention centers and sports facilities) may continue to be financed with qualified small-issue bonds.

d. Section 501(c)(3) organization bonds

The bill permits continued tax-exemption for interest on bonds issued for the benefit of section 501(c)(3) organizations.[52] Interest on section 501(c)(3) organization bonds is tax-exempt, however, only if all of the net proceeds of the bonds (i.e., all proceeds other than proceeds used to pay costs of issuance and amounts invested in a reasonably required reserve or replacement fund) are used in activities directly related and essential to the conduct of the charitable activities of the organization. Additionally, facilities financed with section 501(c)(3) organization bonds must be owned by a section 501(c)(3) organization, or else by (or on behalf of) a qualified governmental unit. These general provisions apply both to bonds

[52] These bonds are subject to the new unified State volume limitation applicable to bonds for nongovernmental persons; however, as discussed in 4., below, a portion of each State's volume limit is reserved specifically for such bonds.

issued to provide hospital facilities and to other section 501(c)(3) organization bonds.

If any portion of the net proceeds of an issue of section 501(c)(3) organization bonds is used by a nongovernmental person other than a section 501(c)(3) organization, interest on the issue is taxable. For example, section 501(c)(3) organization bonds may not be used to finance office space for use by nongovernmental persons in carrying on trades or businesses. Additionally, the committee intends that no portion of the proceeds of a section 501(c)(3) hospital bond may be used to finance an office building for use by physicians in carrying on the private practice of medicine (regardless of whether the ownership or operation of the office building is a related trade or business to that of the section 501(c)(3) organization). Similarly, no portion of the net proceeds of these bonds may be used to finance any other facilities that are leased to or operated by other nongovernmental persons if the use pursuant to the lease or other arrangement would result in the bonds being nonessential function bonds were the section 501(c)(3) organization a governmental unit.[53]

As under present law, the use of bond proceeds by section 501(c)(3) organizations in unrelated trades or businesses (as determined by applying sec. 513(a)) is a nonexempt use. Thus, use of bond proceeds or of bond financed property in such an unrelated trade or business results in interest on the issue being taxable. (A small-issue bond could, however, be used for such a purpose.)

The committee understands that certain facilities eligible for financing with section 501(c)(3) organization bonds may comprise part of a larger facility otherwise ineligible for such financing or that portions of a section 501(c)(3) organization facility may be used for activities of persons other than section 501(c)(3) organizations. The committee intends that the Treasury Department may adopt rules for allocating the costs of such mixed use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility. Only the portions of such mixed use facilities owned and used by a section 501(c)(3) organization may be financed with bonds for such organizations.

$150 million limitation for non-hospital section 501(c)(3) organization bonds

General rules

The bill limits the aggregate amount of outstanding tax-exempt bonds (other than qualified hospital bonds) from which any section 501(c)(3) organization may benefit. Bonds subject to this provision include both section 501(c)(3) organization bonds and all other nonessential function bonds (e.g., small-issue bonds) from which a section 501(c)(3) organization benefits. Bonds, the proceeds of which are used to finance hospital facilities, are not subject to the limitation and are not counted in determining how many bonds are allo-

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[53] *See*, Rev. Proc. 77-352, *supra*, for an example of circumstances under which use of section 501(c)(3) organization facilities by other nongovernmental persons may result in the facilities being treated as used in the other person's trade or business.

cated to a section 501(c)(3) organization that operates a hospital and also carries out other activities (e.g., a medical school, a nursing home facility, an ambulatory care facility, or a research laboratory. Such organizations may have up to $150 million of bonds outstanding for such nonhospital facilities, in addition to any bonds for actual hospital facilities, if the other facilities are directly related and essential to the purpose qualifying the organization for exemption from tax.) For purposes of the $150 million limitation, qualified student loan bonds used to finance loans to students at a section 501(c)(3) educational institution are not allocated to the institution.

An issue of section 501(c)(3) organization bonds is denied tax-exemption if the aggregate authorized face amount of the issue, when increased by the face amount of all other types of tax-exempt bonds (not including section 501(c)(3) hospital bonds) outstanding and allocated to the section 501(c)(3) organization, exceeds $150 million. In determining whether the $150 million limitation has been exceeded, however, bonds that are to be redeemed with the proceeds of the new issue are not considered.

In general, the face amount of such bonds will be allocated in its entirety to one or more section 501(c)(3) organization that both owns and uses the bond-financed property. The committee is aware that section 501(c)(3) organizations also may lease or otherwise be a principal user of a portion of property financed with other types of tax-exempt bonds. For example, a section 501(c)(3) organization may lease office space in a building financed with an issue of small-issue bonds. In such cases, property leased or otherwise principally used by a section 501(c)(3) organization is to be allocated to that organization for purposes of the $150 million limitation.

The $150 million limitation generally is to be administered in a manner similar to the present $40 million limitation for small-issue bonds. For example, bonds generally are to be allocated only among those persons (including section 501(c)(3) organizations) who are test-period beneficiaries. Test-period beneficiaries are defined as owners or principal users of the facilities being financed by the issue at any time during the three-year period beginning on the later of (1) the date such facilities are placed in service, or (2) the date of the issue. No portion of an issue generally is allocated to persons other than owners and principal users during this three-year test period. It is intended that this rule may not be used to avoid the intended effect of the $150 million limitation.

As under the $40 million limitation, all owners of bond-financed facilities during the three-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. All principal users of the facilities during the three-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them.

In determining whether a portion of an issue is allocated to a section 501(c)(3) organization, the related person rules generally applicable to small-issue bonds apply. For example, a university and all related persons (as defined in sec. 267), including related entities engaged in unrelated trades or businesses, are treated as one person in determining whether they are principal users of bond-financed property. The committee intends that any section 501(c)(3)

organization will be treated as related to any other person if the two have (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. For example, a local chapter of a national organization is related to its national organization. The committee further intends that any section 501(c)(3) organization is to be treated as related to any other person if it either owns 50 percent or more of the capital interests or the profit interests in the other. Finally, any section 501(c)(3) organization is related to any other such organization with respect to a particular transaction if such transaction is part of an attempt to avoid the application of the Act.

Once a portion of an issue is allocated to a section 501(c)(3) organization, that allocation remains in effect as long as the bonds are outstanding. This is true even if the person or organization no longer owns or uses the property financed with the bonds. Similarly, the fact that persons are no longer related persons after an allocation is made does not alter the allocation to that person as long as the bonds are outstanding.

Bonds issued before January 1, 1986, also are allocated to section 501(c)(3) organizations if the bonds are outstanding on that date. The committee intends that the determination of test-period beneficiaries of bonds issued more than three years before January 1, 1986, that are outstanding on that date, be made by reference to the owners and principal users of the bond-financed facilities on January 1, 1986. If an organization is allocated $100 million in all types of tax-exempt bonds as of January 1, 1986, the maximum amount of additional section 501(c)(3) organization bonds from which the organization may benefit is limited to $50 million, until some or all of the outstanding bonds are redeemed. If an organization is allocated $150 million or more of bonds on January 1, 1986, no additional bonds may be issued until that allocation falls below $150 million following redemption of some or all of the bonds.

If an issue of section 501(c)(3) organization bonds causes the $150 million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable. If the $150 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued. In no case does this restriction affect the tax-exemption of interest on bonds issued prior to January 1, 1986.[54]

Exception for qualified hospital bonds

The $150 million limitation does not apply to bonds used to finance qualified hospital facilities. A hospital is a facility that—

(1) is accredited by the Joint Commission on Accreditation of Hospitals (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the ac-

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[54] The tax-exempt status of bonds issued pursuant to transitional exceptions to this rule similarly is not affected; however, these bonds (like bonds issued before 1986) are counted in determining how many bonds are allocated to a section 501(c)(3) organization.

creditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH;

(2) is primarily used to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(3) has a requirement that every patient be under the care and supervision of a physician; and

(4) provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times.

The term hospital does not include rest or nursing homes, day-care centers, medical school facilities, research laboratories, or ambulatory care facilities (e.g., surgicenters).

e. Student loan bonds

The bill continues the tax-exemption for interest on qualified student loan bonds, generally defined as under present law. These bonds include bonds issued by qualified governmental units or by qualified scholarship funding corporations in connection with certain programs of the United States Department of Education.

The bill also expands the definition of qualified student loan bond to include obligations to make or finance loans under certain State supplemental loan programs. Programs qualifying for this financing include any program of general application approved by the State to which part B of title IV of the Higher Education Act of 1965 (relating to guaranteed student loans) does not apply, if loans under the program are limited to the difference between (1) the total cost of attendance and (2) other forms of student assistance. For purposes of determining other forms of student assistance, loans made pursuant to section 428B(a)(1) of the Higher Education Act Of 1965 (relating to parent loans), and loans made pursuant to subpart C.I of Title VII of the Public Health Service Act (relating to certain student assistance), are not taken into account.

As under present law, issuers of tax-exempt student loan bonds (other than bonds not issued in connection with a Department of Education guarantee) may not restrict availability of bond-financed loans based upon (1) legal residence of individuals attending schools located within the State, or (2) the location of schools attended by legal residents of the issuing State. Rather, loans financed with these bonds must be available on a nondiscriminatory basis to all individuals attending schools located within the State and to all legal residents of the State, regardless of the location of the schools they attend. As is required with respect to all nonessential function bonds, all student loan bond proceeds (other than proceeds used to pay costs of issuance and amounts invested in a reasonably required reserve or replacement fund) must be used to make or finance loans to individuals for educational expenses.

f. Qualified redevelopment bonds

In general

The bill provides tax-exemption for the interest on a new category of bonds issued by qualified governmental units, qualified rede-

velopment bonds. Qualified redevelopment bonds are bonds which are part of an issue (1) all the net proceeds of which are to be used for redevelopment purposes in a locally designated blighted area, and (2) with respect to which property tax revenues (or their equivalent) attributable to any increase in real property values by reason of bond-financed redevelopment is reserved exclusively for debt service on the issue, to the extent necessary to cover such debt service. The fact that a local government lends its full faith and credit to these bonds, in addition to earmarking incremental tax revenues, does not affect their status as qualified redevelopment bonds.

Real property taxes imposed in the designated blighted area must be imposed at the same rate and in the same manner as taxes on other real property located in the same jurisdiction. Additionally, no owner or user of property in the designated area may be subject to a charge or fee (other than real property taxes) which is not imposed on similarly situated owners or users in the designated area or elsewhere in the jurisdiction.

Qualified redevelopment bonds may be issued only pursuant to a State law which authorizes the issuance of such bonds for use in blighted areas. Additionally, the bonds must be issued pursuant to a redevelopment plan adopted by the governing body of the general purpose local governmental unit (e.g., the city, or if not located in a city, the county) having jurisdiction over the designated blighted area, before the issuance of the bonds.

Qualified redevelopment bonds may not be repaid, and the repayment of the bonds may not be secured, by any nongovernmental person, other than by means of incremental real property tax revenues (as described above). Thus, bonds which are IDBs under present law may not be qualified redevelopment bonds.

These new restrictions do not affect the tax status of bonds used for governmental activities such as construction and repair of streets and sidewalks or other similar essential governmental functions. For a description of the rules governing such bonds, see the discussion of bonds for essential governmental functions, above.

Qualified redevelopment activities

Qualified redevelopment bonds may be used only for specified redevelopment purposes. The purposes for which these bonds may be issued are (1) to acquire (pursuant to the power of eminent domain or the threat of exercise thereof) real property in a designated blighted area, which real property is subsequently to be transferred to nongovernmental persons, (2) to clear and prepare land in a designated blighted area for redevelopment and transfer to a nongovernmental person, (3) to rehabilitate (or otherwise redevelop) the real property, and (4) to relocate occupants of structures on the acquired real property.

Designation of blighted areas

Only activities in specially designated blighted areas may be financed by qualified redevelopment bonds. These include areas designated as blighted areas by the governing body of the general purpose local governmental unit in which the area is located, pursuant to a plan adopted before issuance of the bonds. The designation of

blighted areas is to be based on State statutory criteria which take into account the presence of the following indicators in the area: excessive vacant land on which structures were previously located; abandoned or vacant buildings; structurally substandard buildings; old buildings generally; excessive vacancies; and delinquencies in the payment of real property taxes.

The aggregate blighted areas designated by any governmental unit may not contain real property the assessed value of which exceeds 10 percent of the total assessed value of all real property located within the jurisdiction of the governmental unit.[55] Additionally, no blighted area may be smaller than one-fourth square mile in area. The committee intends that the designation of blighted areas will be made in contemplation of a redevelopment of the entire designated area and that areas will not be artificially designated in order to allow bond financing for one or a few specific facilities which happen to be located within the area. The committee also intends that local jurisdictions that presently have areas in excess of the 10 percent maximum designated as blighted will review those areas to reduce the aggregate areas eligible for redevelopment activities financed with these bonds before being eligible to issue qualified redevelopment bonds.

For purposes of designating redevelopment areas, general purpose local governmental units are to be the smallest governmental units having general purpose sovereign powers over a given area.[56] Thus, in most cases, designations will be made by cities or (for areas outside any city) by county governments. The State itself and special purpose governmental units (e.g., a redevelopment authority or agency) are not treated as a governmental unit entitled to designate blighted areas.[57]

Restrictions on certain uses of proceeds

Qualified redevelopment bonds are subject to the new unified volume limitation for nonessential function bonds and, generally, to the other limitations applicable to nonessential function bonds, other than the rules regarding acquisition of land. (A portion of the unified volume limitation for certain States is reserved initially for such bonds.) The following specific requirements apply to qualified redevelopment bonds used for the indicated purpose:

Single-family housing.—Qualified redevelopment bonds may be used to finance any redevelopment of land on which owner-occupied residences will be located or to rehabilitate such residences only if (1) the first purchaser of each financed residence reasonbly expects to occupy the residence as his or her principal residence, and (2) the purchase price of each residence does not exceed the purchase price limitation which would apply for purposes of qualified mortgage bond financing in the same location. (*See*, discussion of qualified mortgage bond rules above.) This restriction applies re-

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[55] An area is treated as a designated area for purposes of this restriction until all qualified redevelopment bonds used to finance activities therein are redeemed.

[56] This is similar to the test applied for purposes of allocating bond authority among overlapping units, see 4., below.

[57] The State is, however, required to establish the criteria for designating these areas, as described above.

gardless of whether any of the mortgage loans for the residences are financed with the proceeds of such bonds.

Multifamily residential rental property.—Multifamily residential rental units that are rehabilitated with, or are constructed on land any part of the preparation of which was financed with, qualified redevelopment bonds must satisfy all Code requirements applicable to qualified multifamily residential rental projects. These restrictions apply whether or not the residential rental units themselves are financed with tax-exempt bond proceeds. The restrictions apply throughout the qualified project period, as defined for purposes of multifamily housing bonds.

Prohibited uses.—Qualified redevelopment bonds may not be used to finance any facility, the financing of which is restricted or prohibited in the case of small issue bonds or nonessential function bonds generally (new secs. 144(a)(8) and 146(e)).

4. Unified State volume limitation applicable to bonds for the benefit of nongovernmental persons

The three separate sets of volume limitations that apply under present law to (1) IDBs and student loan bonds, (2) qualified veterans' mortgage bonds, and (3) qualified mortgage bonds are replaced with a unified limitation on the aggregate annual amount of bonds for the benefit of nongovernmental persons that a State and other qualified governmental units therein may issue.

a. Allowable bond volume

General rules

The annual volume limitation for each State is equal to the greater of (1) $175 for every individual who is a resident of the State (as determined by the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the calendar year to which the limitation applies), or (2) $200 million. The $175 per capita limitation continues until 1988, at which time that amount will be reduced to $125 per capita to reflect the termination of the exception permitting issuance of qualified mortgage bonds. (The $200 million limitation will not be reduced at that time.)

For purposes of the volume limitation, the District of Columbia is treated as a State (and therefore may receive a $200 million volume limitation). U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are limited to the $175 per capita amount.

Special set-aside for section 501(c)(3) organization bonds

A portion of each State's unified volume limitation is set aside for exclusive use by section 501(c)(3) organizations. This set-aside is equal to $25 per resident of the State; in the case of States subject to the $200 million per year minimum volume limitation, this reserved portion is equal to $30 million. The set-aside amount may not be changed by State action, either legislative or gubernatorial; however, under the allocation rules described below, a State may determine what issuers within the State are to be authorized to issue bonds under the set-aside. In addition to the set-aside, section

501(c)(3) organizations may be allocated any amount of a State's remaining unified volume limitation.

The portion of the State volume limitation set aside for 501(c)(3) organizations may not be used to issue student loan bonds or other bonds that are not section 501(c)(3) organization bonds.

b. Bonds subject to the unified volume limitation

Bonds subject to the unified volume limitation include most nonessential function bonds for which tax-exemption is permitted and the nongovernmental portion (in excess of $1 million) of essential function bonds.[58] Specifically, the volume limitation applies to (1) exempt-facility bonds (other than bonds for certain airport, dock, and wharf facilities), (2) qualified mortgage bonds, (3) qualified veterans' mortgage bonds,[59] (4) small-issue bonds, (5) section 501(c)(3) organization bonds, (6) qualified student loan bonds, and (7) qualified redevelopment bonds.[60] Mortgage credit certificates (MCCs) may continue to be issued by a qualified governmental unit provided the aggregate annual volume of MCCs issued does not exceed 20 percent of the volume of unified volume limitation exchanged by the issuer.

As under the present-law State volume limitations applicable to IDBs and student loan bonds, a qualified governmental unit generally may not allocate its bond authority to property to be located outside the State. An exception is provided permitting a qualified governmental unit to allocate a portion of its unified volume limitation to financing for facilities located outside the State's boundaries in the case of specified facilities to the extent of the State's share of the use of those facilities. Facilities located outside a State to which a portion of the unified volume limitation may be allocated include (1) facilities for the furnishing of water, (2) qualified sewage disposal facilities, and (3) solid waste disposal facilities. In the case of facilities for the furnishing of water, the determination of use is based upon the share of the output of the facility received by the State (and its residents). In the case of sewage and solid waste disposal facilities, the determination of a State's share of the use of a facility is based on the percentage of the facility's total treatment provided to the State (and its residents).[61]

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[58] The portion of an essential function bond that may be used in a trade or business of a person other than a qualified governmental unit must be less than an aggregate amount equal to the lesser of 10 percent or $10 million of bond proceeds in the case of trade or business use. In the case of any loans to nongovernmental persons, the aggregate amount of the loans must be less than an aggregate amount equal to the lesser of 5 percent or $5 million of bond proceeds.

[59] The State of Oregon issues certain notes to finance property taxes on residences with respect to which veterans' mortgage loan bonds are outstanding. Under the bill, as under present law, these tax notes are treated as qualified veterans' mortgage bonds. Tax notes are issued for a term not exceeding one year and are retired (rather than refunded) at the end of that year when monthly installments paid by homebuyers equal the property taxes paid with the note proceeds. Under present law, the notes count toward the State veterans' mortgage bond volume limitation at 1/15 of principal amount. Under the bill, these tax notes will count toward the unified volume limitation at 1/15 of their principal amount.

[60] Bonds issued as part of the State of Texas Veterans' Land Bond Program are nonessential function bonds eligible for tax-exemption and are subject to the unified State volume limitation; these bonds are treated as nonhousing bonds for purposes of the special housing set-aside, discussed below.

[61] The fact that loans financed with student loan bonds generally must be available to all individuals attending schools within the issuing State and to all legal residents of the State regardless of the State in which they attend school is not affected by the limitation on financing out-of-state facilities, since those bonds are not used to finance property.

c. Exceptions to the unified volume limitation

Certain exempt-facility bonds

Exempt-facility bonds for certain airport, dock, and wharf facilities are not subject to the unified State volume limitation. Bonds to finance airports are not subject to the limitation to the extent that the bond proceeds are to be used for qualified airport facilities other than cargo handling facilities. Bonds for docks and wharves are not subject to the unified volume limitation to the extent that the bond proceeds are to be used for qualified facilities other than immediate storage facilities.

If a single bond issue is used to construct a qualified airport or dock and wharf facility that includes property subject to the unified volume limitation as well as property exempt from that limitation, only a portion of the issue is subject to the State volume limitation. For example, if a $100 million issue is to be used for the construction of qualified airport facilities, of which 25 percent of the proceeds are to be used for cargo handling facilities, $25 million of the issue is subject to the State volume limitation. Unless an allocation of the State unified volume limitation is made in an amount at least equal to the financing for property subject to the volume limitation, interest on the entire issue is taxable.

The committee is aware that certain qualified airport and dock and wharf facilities may be used both for functions the financing for which is not subject to the unified State volume limitation and for activities subject to that limitation. The committee intends that the general rules described under the discussion of exceptions for exempt-facility bonds for allocating costs of airport and dock and wharf facilities between facilities eligible for bond-financing and those not eligible for such financing apply in determining what portion of an issue for airports or docks and wharves is subject to the unified volume limitation.

Certain refunding issues

Certain refunding bonds are not subject to the volume limitation if (1) the amount of the refunding bonds does not exceed the outstanding amount of refunded bonds and (2) the refunded bonds are redeemed within 30 days of issuance of the refunding bonds. In the case of current refundings of student loan bonds, and of other bonds subject to the unified volume limitation (other than qualified mortgage bonds and qualified veterans' mortgage bonds) where the original bonds were not used to finance facilities (e.g., the nongovernmental portion of essential function bonds), the refunding bonds are not subject to the unified volume limitation only if the maturity date of the refunding obligation does not exceed (1) the maturity date of the refunded obligation, or (2) the date that is 17 years after the date on which the refunded obligation was issued (or in the case of a series of refundings, the date on which the original obligation was issued). This rule is applied in the case of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting

32 years for 17 years.[62] For purposes of the unified volume limitation the term refunding includes a rollover of commercial paper and other comparable actions with respect to so-called "flexible" obligations (e.g., floatng rate obligations, variable rate demand obligations, convertible variable rate demand obligations, or similar nominally long-tern obligations with puts at periodic intervals).,

d. Allocation of unified volume limitation among the State and other qualified governmental units therein

In general

Each State's unified volume limitation is allocated among the various governmental units within the State that are authorized to issue bonds for nongovernmental persons pursuant to a three-step rule. This rule is similar to the allocation rules that apply under the present-law volume limitations applicable to IDBs and student loan bonds and to qualified mortgage bonds.

Under the first step, each State's unified volume limitation is allocated between the State (and its agencies) and local governmental units authorized under State law to issue tax-exempt bonds until either the governor or the legislature makes a different allocation. (Any subsequent allocation for a particular year is reduced by bonds issued under the first allocation.) One-half of the State limitation is allocated to the State (and its agencies having authority to issue tax-exempt bonds for nongovernmental persons). The other one-half of the State's unified volume limitation is allocated to local governmental units.

The allocation to local governmental units having authority to issue bonds is made on the basis of the relative populations of those units. The population estimates to be used in allocating the volume limitation are the most recent population estimates from the Bureau of the Census released before the beginning of the calendar year to which the determination relates. When a determination involves comparison of the population of two or more governmental units, data for the same year must be used.

Where two or more local governmental units overlap, the volume limitation is allocated first to the governmental unit with jurisdiction over the smallest geographical area. The volume limitation for that jurisdiction is determined by multiplying the one-half of the State limitation allocated to issuers other than the State by a fraction, the numerator of which is the most recent population estimate of that governmental unit and the denominator of which is the population of the entire State, using that same data. The remaining portion allocable to the governmental unit with jurisdiction over the larger area is equal to one-half of the State's unified volume limitation multiplied by a fraction the numerator of which is the population of the larger governmental unit not residing in the smaller governmental unit and the denominator of which is the population of the entire State.

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[62] The maturity of nonessential function bonds (including refunding bonds) the proceeds of which are used to finance facilities generally is limited to 120 percent of the economic life of the property being financed. (*See* 6., below.)

Where two governmental units have authority to issue bonds for nongovernmental persons and both governmental units have jurisdiction over the identical geographical area, the portion of the State volume limitation allocable to that area is allocated to the governmental unit having the broader sovereign powers. For example, where a city and an industrial development authority for the city (that is itself a governmental unit) both are authorized to issue such bonds, then the portion of the State ceiling allocable to the city based upon the population of that city is allocated to the city since the city has broader sovereign powers.

Under the second step, the governor of each State is provided authority to allocate during an interim period the State's unified volume limitation among all of the governmental units and other issuing authorities (both State and local) having authority to issue bonds subject to the limitation. This power of the governor to allocate the State limitation and any allocation rules established by the governor terminate after the first day of the first calendar year beginning after the first calendar year after 1985 during which the legislature of the State met in regular session. This authority and any allocation rules the governor establishes terminate earlier than this date if overriding State legislation having an earlier effective date is enacted.

Under the third step, the State legislature may enact a law providing for a different allocation than that provided in step one. Under this authority, the State legislature may allocate all or any portion of the State limitation to any governmental unit or other issuing authority in the State that has authority to issue bonds subject to the unified volume limitation. State legislation enacted before enactment of the bill is recognized for this purpose if that legislation refers specifically to the new unified volume limitation.

The committee intends that a State be permitted to allocate available bond volume authority to a local issuer until a specified date during each year (e.g., November 1) at which time the authority, if unused, reverts to the State for reallocation. Similarly, a State statute may provide discretionary authority to a public official (e.g., the governor) to allocate the State's volume limitation. Because the unified volume limitation is an annual amount, however, any authority that has not been used for bonds issued before the end of the calendar year expires (unless a special carryforward election, discussed below, is made).

Special rule for constitutional home rule subdivisions

The bill provides a special allocation rule for certain political subdivisions with home rule powers under a State constitution (Illinois). The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule powers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971. In that State, a full portion of the State volume limitation is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State. As is true of the other volume limitation determinations, this allocation is made using the most recent population estimate

from the Bureau of the Census released before the beginning of the calendar year to which the bonds relate. The amount so allocated to home rule subdivisions may not be altered by the power to provide a different allocation otherwise granted by the bill to the governor or the State legislature. However, a home rule subdivision may agree to a different allocation.

The portion of a State's unified volume limitation not allocated to constitutional home rule cities then is allocated among the other governmental units in the State having authority to issue bonds subject to the volume limitation under essentially the same three steps described in the previous section. Thus, under the first step, one-half of the remaining State limitation is allocated to the State and its agencies. The other one-half of the remaining State limitation is allocated to the localities outside of the home rule cities, based upon the ratio that the population of each of those localities outside of home rule subdivisions bears to the population of the State's residents located outside of home rule cities. Under the second and third steps described above, the governor or the State legislature may allocate the State limitation other than that allocated to home rule subdivisions to any governmental units that have authority to issue bonds for nongovernmental persons (including home rule subdivisions), but they may not so allocate any amount specially allocated to the home rule subdivisions.

For purposes of the rules on State action establishing allocation rules for the unified volume limitation, a mayor of a constitutional home rule city is treated as a governor, and a city council is treated as a State legislature.

Constitutional home rule cities are treated as States for purposes of the unified volume limitation set-asides for section 501(c)(3) organization bonds, housing bonds, and qualified redevelopment bonds. Pursuant to their general authority to alter bond allocation, described above, these cities may agree with the State in which they are located to exchange section 501(c)(3) organization bond authority for authority to issue other types of bonds.

Allocation of certain set-aside amounts

Section 501(c)(3) organizations

As described above, a portion of each State's volume limitation is set aside exclusively for section 501(c)(3) organization bonds. The amount of this set-aside is equal to $25 per resident of the State ($30 million in the case of States subject to the $200 million limitation). A proportionate amount of the unified volume limitation allocated to the State and each other qualified governmental unit in the State is restricted initially for use for section 501(c)(3) organization bonds.

Although the overall amount of bond authority set aside for these bonds may not be reduced by any State action, a State may enact a statute determining which issuers in the State may issue section 501(c)(3) organization bonds and may allocate the entire set-aside amount to those issuers. Similarly, during the interim period provided for gubernatorial allocations, a governor may determine what issuers may issue bonds under this set-aside. For example, a State may choose to allocate this set-aside exclusively to a State

higher education finance authority. The amount of the remaining unified volume limitation allocated to all other issuers must, of course, be adjusted to take into account any reallocation of this set-aside amount.

Housing uses

Unless overridden by a State statute, at least 50 percent (reduced to 25 percent after 1987 to reflect the sunset of authority to issue qualified mortgage bonds) of the portion of each State's annual unified volume limitation not reserved for section 501(c)(3) organizations is required to be reserved for (1) exempt-facility bonds for multifamily residential rental projects, (2) qualified mortgage bonds, or (3) qualified veterans' mortgage bonds. For example, a State subject to the $175 per capita limitation in 1986, unless overridden by State statute, must set aside $75 per capita for these housing bonds.

As is true of the set-aside for section 501(c)(3) organization bonds, the allocation of each issuer within the State is subject to this housing set-aside. Also, while the set-aside may be changed only by State statute, the governor may determine which issuers are authorized to issue housing bonds and may allocate all or any portion of the housing set-aside to those issuers during the interim period described above. The amount of remaining unified volume limitation allocated to all other issuers must, of course, be adjusted to take into account any reallocation of this set-aside amount by the governor.

Further, unless overridden by the Governor or a State statute, until 1988, at least one-third of this 50-percent allocation must be reserved for exempt-facility bonds for multifamily residential rental projects and at least one-third for qualified mortgage bonds and/or qualified veterans' mortgage bonds.

Qualified redevelopment bonds

Unless overridden by a State statute, at least $6 per capita (or $8 million in the case of States having a $200 million limit) of the portion of each State's annual unified volume limitation not reserved for section 501(c)(3) organizations is required to be reserved for qualified redevelopment bond activities. This set-aside applies only to States that issued more than $25 million in tax-increment financing bonds during the period beginning on July 18, 1984, and ending on December 31, 1985.[63] (Tax-increment bonds are defined for this purpose as provided in Title XIV of the bill, relating to technical corrections to the 1984 Act.) This set-aside amount is subtracted one-half from the non-housing portion of the State's volume limitation and one-half from the housing portion for any year in which the housing set-aside is in effect for the State.

As is true of the set-aside for section 501(c)(3) organization bonds, the allocation of each issuer within the State is subject to this qualified redevelopment bond set-aside. Also, while the set-aside may be changed only by State statute, the governor may determine which issuers are authorized to issue redevelopment bonds and

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[63] The determination of whether more than $25 million in tax-increment bonds were issued during this period is made separately in the case of constitutional home rule cities.

may allocate all or any portion of the redevelopment bond set-aside to those issuers during the interim period described above. The amount of remaining unified volume limitation allocated to all other issuers must, of course, be adjusted to take into account any reallocation of this set-aside amount by the governor.

e. Three-year carryforward

An issuer may elect to carry forward any portion of its unified volume limitation for up to three years for specific projects. A carryforward election, once made, is irrevocable. The election may not be made for projects to be financed with small-issue bonds. Where the election applies, obligations issued in the three calendar years following the calendar year for which the election is made are not counted towards the State's unified volume limitation in the year of issuance to the extent that the proceeds from the obligations are used to finance the project specified in the election. The bond authority specified in carryforward elections is absorbed in the order in which the obligations for the specified project are issued.

The election to carry forward unused State volume limitation is to be made as provided in Treasury Department regulations. Identification of a project with reasonable specificity is required to make a valid carryforward election. In general, this requirement is satisfied if a project is identified by its address, name of intended owner, lessee, etc., and the general type of financing. The committee intends that, in the case of sewage and solid waste disposal facilities that will process waste from the general public of the issuing governmental unit, reasonable identification need not include a specific street address. On the other hand, in the case of facilities that are identified more specifically with a limited group of users or more than one of which may be financed within the jurisdiction of the issuing governmental unit, a specific (e.g., street) address appropriately is required when the carryforward election is made.

The purpose of issuing student loan bonds, of issuing qualified veterans' mortgage bonds, of issuing qualified mortgage bonds, or of issuing mortgage credit certificates is considered a separate project that is adequately specified for purposes of the carryforward election. The authority to carryforward authority to issue qualified mortgage bonds and mortgage credit certificates is limited to bonds or credits that will be issued before 1988, due to the scheduled expiration of authority to issue those bonds (and credits) after 1987.

Except as provided above, no part of any State's volume limitation may be carried forward to any portion of a succeeding year. Similarly, a State may not borrow against future volume limitations.

5. Arbitrage restrictions

The bill makes numerous technical amendments to the general arbitrage restrictions applicable to all tax-exempt bonds; extends to all tax-exempt bonds both a requirement that certain arbitrage profits be rebated to the Federal Government and a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations; restricts advance refundings; and restricts the early issuance of tax-exempt bonds.

a. General arbitrage restrictions applicable to all bonds

Permissible arbitrage profits

Repeal of minor portion rule

The bill amends the general arbitrage restrictions applicable to all tax-exempt bonds to delete the rule that a minor portion (15 percent) of bond proceeds may be invested in materially higher yielding obligations. The present-law exception for reasonably required reserve or replacement funds is retained, and exceptions for certain initial temporary periods when unlimited arbitrage is permitted are retained, subject to new restrictions. Therefore, except in cases where one of these exceptions applies to an issue, no portion of the proceeds of the issue may be invested in materially higher yielding obligations.

In general, the present-law definitions of materially higher yield are retained. Thus, under the bill, permissible arbitrage profits generally are limited to 0.125 percentage points (plus certain costs depending on whether the investments are acquired purpose obligations or acquired nonpurpose obligations) above the yield on the bond issue. In the case of acquired program obligations, the present-law restriction of 1.5 percentage points (plus certain costs) continues to apply.

Expansion of investments subject to yield restrictions (including annuities to fund pension plans)

The bill also provides additional restrictions on the types of obligations in which bond proceeds may be invested without regard to yield restrictions.[64] Under the bill, the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under the Code. Thus, investment in any taxable security as well as any deferred payment contract (e.g., an annuity) or other property held for investment is precluded if the yield on the property is materially higher than the yield on the bonds. This restriction applies regardless of the purpose of the investment (e.g., whether the investment is acquired as an acquired purpose obligation, an acquired nonpurpose obligation, or an acquired program obligation). Under this rule, for example, the purchase of an annuity contract to fund a pension plan of a qualified governmental unit would be subject to the same arbitrage restrictions as would direct funding of that plan with bond proceeds. The purchase of bond insurance is not considered to be the purchase of an annuity contract. Similarly, investment of bond proceeds in any other type of deferred payment investment-type contract to fund an obligation of the issuer or bond beneficiary would be subject to these yield restrictions. The restriction would not apply, however, to real or tangible personal property acquired with bond proceeds for reasons other than investment (e.g., courthouse facilities financed with bond proceeds).

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[64] Section 648 of the Deficit Reduction Act of 1984 provides that, in certain cases, property held in the Permanent University Fund of the University of Texas and Texas A&M University is not treated as an investment of bond proceeds for purposes of the Code arbitrage restrictions. The bill does not affect this provision regarding the Permanent University Fund.

Clarification of reasonable expectations test

The bill codifies the application of the present-law reasonable expectations test as it applies to subsequent acts to earn arbitrage. As under present law, the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent intentional acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test will not prevent the bonds from being arbitrage bonds. *See*, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47.

For purposes of this continuing requirement, any investment with respect to which impermissible arbitrage earnings accrue will results in the bond interest becoming taxable, retroactive to the date the bonds are issued. The committee intends that the determination of whether intentional actions to earn arbitrage have been taken is made on a case-by-case basis, taking into account all facts and circumstances that a prudent investor would consider in determining whether to invest bond proceeds.

Exceptions to yield restriction requirement

Election to forego temporary periods

Under the bill, the right to elect under Treasury Department regulations to forego a temporary period during which unlimited arbitrage earnings are permitted and by doing so receive the right to earn arbitrage of 0.5 percentage points over the yield of the issue is eliminated. Thus, the definition of the term materially higher generally is limited to 0.125 percentage points over the yield on the issue.

Restriction of temporary period exceptions

The bill restricts the exception to the general arbitrage restrictions under which unlimited arbitrage profits may be earned during certain temporary periods.[65] In the case of bond proceeds used to acquire property, the temporary period is limited to 30 days. In the case of such proceeds used for construction (including reconstruction or rehabilitation) of property, the temporary period ends on the earliest of—

(1) The date on which the construction of the project is substantially (i.e., 90 percent) completed;[66]

(2) The date on which an amount (whether of bond proceeds or other funds) equal to the amount of the bonds has been spent on the property; or

(3) The date which is three years after the earlier of the date the bonds are issued or the date construction on the project commences.

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[65] These statutory temporary periods are in lieu of all other temporary periods permitted under present Treasury Department regulations (e.g., Treas. Reg. sec. 1.103-14) to the extent that bond proceeds are used for acquisition or construction of facilities. Additionally, unlike the period for expenditure of bond proceeds under the restrictions on early issuance discussed below, these temporary periods may not be extended. Any funds remaining after the end of the temporary period must be yield restricted.

[66] A project will be treated as substantially completed if construction on the project is, at any time, delayed (other than brief delays occurring in the ordinary course of business) or abandoned.

The committee recognizes that many projects involve both construction of property and acquisition of property. For example, a single issue of bonds may be issued to finance construction of a building and the acquisition of equipment to be used in the building. Additionally, the committee is aware that qualified governmental units frequently issue composite bonds to fund various activities of the governmental units themselves. In such cases, the committee intends that the allowable temporary period for the bond issue be determined separately based upon the different uses for which the bond proceeds are to be used.

For example, assume that one-fifth of the proceeds of an issue of governmental bonds is to be used to finance acquisition of a new computer by a city transportation department; three-fifths is to be used to finance construction of new offices for the city planning department; and the remaining one-fifth is to be used to finance general governmental operations (e.g., salaries of government employees, etc.) In this case, portions of the issue will have different temporary periods based on the percentage of proceeds to be used for each of the three purposes of the financing. The temporary period for the one-fifth of the proceeds used for the computer is 30 days; the temporary period for the three-fifths used for construction is limited to a maximum of three years; and the temporary period for the remaining one-fifth is determined as under present law.

Similarly, assume a small-issue bond is issued to finance a loan for construction of a manufacturing plant and for purchase of equipment to be used in the plant. Assume further that 75 percent of the proceeds is to be used for contruction and the remaining 25 percent for purchase of the equipment. The allowable temporary period for the 75 percent of the issue to be used for construction is limited to a maximum of three years. The allowable temporary period for the remaining 25 percent of the issue to be used for acquisition of equipment is 30 days.

Treasury Department regulations for student loan bonds

The bill retains the present-law direction to the Treasury Department to develop special arbitrage regulations for qualified student loan bonds, to the extent that this direction is not inconsistent with the rebate requirements and restrictions on investment in nonpurpose obligations included in the bill. Therefore, as provided in the 1984 Act, the Treasury is authorized to adopt arbitrage regulations providing that the provisions of present law regarding the treatment of SAP payments and the temporary period and reasonably required reserve or replacement fund rules of the Code do not apply to qualified student loan bonds. These regulations, when adopted, will be effective as provided in the 1984 Act.

Determination of bond yield

The bill provides that, under all arbitrage restrictions applicable to tax-exempt bonds, the yield on an issue is determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274). This amendment reverses the holding in the case *State of Washington* v. *Commissioner, supra.*

b. Extension of additional arbitrage restrictions to all bonds

The bill extends to all tax-exempt bonds (including refunding issues) additional arbitrage restrictions similar to those presently applicable to most IDBs and to qualified mortgage bonds. These restrictions, requiring the rebate of certain arbitrage profits and limiting investment of bond proceeds in nonpurpose obligations, are in addition to the general arbitrage restrictions for all tax-exempt bonds. For purposes of these requirements, the term refunding includes a rollover of commercial paper and comparable actions with respect to similar, so-called "flexible" obligations (e.g., floating rate obligations, variable rate demand obligations, convertible variable rate demand obligations, or similar nominally long-term obligations with puts at periodic intervals).

Requirement of rebate of certain arbitrage profits for bonds other than mortgage subsidy bonds

General rules

As currently required of most IDBs, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of tax-exempt bonds must be rebated to the United States. Nonpurpose obligations generally include all obligations other than those specifically acquired to carry out the governmental purpose for which the bonds are issued. For purposes of these additional arbitrage restrictions, obligations invested in a debt service reserve fund are considered to be nonpurpose obligations. The committee intends that the term gross proceeds be interpreted broadly, as under the present-law IDB restrictions. Gross proceeds are the total proceeds of an issue, including the original proceeds of the bonds, the investment return on obligations acquired with the bond proceeds (including repayment of principal), and amounts used or available to pay debt service on the issue.

Arbitrage profits that must be rebated include (1) the excess of the aggregate amount earned on all nonpurpose obligations (other than income earned on the arbitrage itself) over the amount that would have been earned if all nonpurpose obligations were invested at a yield equal to the yield on the issue, plus (2) any income earned on the arbitrage. The yield on the issue is determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274).

The committee is aware that qualified governmental units frequently commingle bond proceeds with tax and other revenues during temporary periods when unlimited arbitrage on the bonds is permitted. This commingling differs from practices used in connection with most financing for nongovernmental persons. In general, the rebate requirement of the bill requires separate accounting for bond proceeds, since issuers must rebate arbitrage regardless of whether the bond proceeds are commingled with other amounts. The committee intends, however, that the Treasury Department may prescribe simplified methods of accounting for governmental bond proceeds in the case of issuers issuing limited amounts of bonds (determined on an annualized basis) where requiring separate accounting otherwise would result in undue hardship.

In determining the amount of arbitrage profits earned on an issue, costs associated with nonpurpose obligations or the bond issue itself are not considered. Therefore, the determination is made without regard to issuance costs and underwriter's discount. Additionally, gain or loss realized on the disposition of any nonpurpose obligations at fair market value is included in determining the aggregate amount earned on such obligations. The deflection of arbitrage through the purchase or sale of nonpurpose obligations at other than fair market value is prohibited.

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due 30 days after retirement of the issue. The committee is aware that there may be rebatable arbitrage profits with respect to a particular issue during one five-year period followed by a negative arbitrage posture during the next five-year period, or *vice versa*. The requirement that only 90 percent of the arbitrage profits be rebated with a final "settling up" after retirement of the bonds reflects the committee's understanding that exact determinations might not be possible during the period that the bonds are outstanding. Therefore, subsequent payments will reflect overpayments and underpayments during previous periods.

The amount subject to rebate is not taxable and the rebated amount is not deductible for Federal income tax purposes.

Exceptions to requirement of rebate

The rebate requirement does not apply to an issue if all gross proceeds of the issue are expended within six months of the issue date for the governmental purpose for which the bonds are issued. In the case of bonds issued as part of a series, only one six-month period is allowed; that period begins on the date on which the first bonds in the series are issued. Under this rule, for example, only one six-month period is allowed with respect to commercial paper and comparable forms of so-called "flexible" obligations. Similarly, only one six-month period is available with respect to a single issue of bonds where more than one draw-down of proceeds is anticipated or occurs.

Also as under present law, a second exception is provided for certain temporary investments related to debt service. Under this exception, if less than $100,000 is earned on a bona fide debt service fund in a bond year with respect to an issue, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider such amount when determining the amount of the rebate otherwise due with respect to the issue. This election must be made at the time of, or before, issuance of the bonds, and the election, once made, is irrevocable.

Requirement of rebate of certain arbitrage profits for mortgage subsidy bonds

The bill retains the provisions of present-law that require either crediting of certain arbitrage profits on qualified mortgage subsidy bonds to mortgagors or rebate of those earnings to the Federal Government. In addition, the bill extends these arbitrage restrictions to qualified veterans' mortgage bonds.

Restriction on investment in nonpurpose obligations for all bonds

In addition to the rebate requirement, the Act extends to all bonds not presently subject to the requirement (i.e., bonds other than most IDBs and qualified mortgage bonds) a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations. Under the bill, the amount of proceeds that may be so invested at a yield above the bond yield at any time during a bond year is limited to 150 percent of the debt service for the bond year. These investments must be reduced as the bond issue is repaid. This restriction does not apply to amounts invested for the initial temporary periods during which unlimited arbitrage profits may be earned and for temporary periods related to current debt service. (The rebate requirement does apply, however, to such amounts if the gross proceeds are not expended for the governmental purpose of the borrowing within six months.)

For purposes of this restriction, debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year. This restriction does not, however, require the sale or other disposition of any investment if that disposition would result in a loss that exceeds the amount that otherwise would be paid to the United States assuming a payment was due at that time.

c . Restriction on advance refundings

The bill prohibits advance refundings of any issue other than an issue of essential function (i.e. governmental) bonds. Thus, no nonessential function bonds may be advance refunded. A refunding is an advance refunding in any case where the refunded bonds are not redeemed (e.g., called in such a manner than no further interest accrues on the bonds) no later than 30 days after the refunding bonds are issued. For purposes of the restriction on advance refundings, an issue is an issue of essential function bonds if it (1) is comprised of bonds that are not nonessential function bonds as defined under the bill, or (2) was when issued comprised of bonds other than IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, private loan bonds, bonds to benefit section 501(c)(3) organizations, or non-Code bonds comparable to these bonds for nongovernmental persons. [67]

Advance refundings when permitted are subject to the following restrictions:

(1) Each original issue of bonds may be advance refunded no more than two times;[68]

(2) Unless the present value of interest savings resulting from the advance refunding exceeds the costs of issuance of the advance refunding bonds, the aggregate amount of advance refunding bonds issued with respect to an original issue may not exceed 250 percent of the amount of the refunded (i.e., original) bonds;

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[67] Bonds that may not be currently refunded as a result of any provision of the bill or of present law (or that may not be advance refunded under present law) may not be advance refunded under this provision.

[68] In determining whether an issue may be advance refunded under this provision, all advance refundings that have occurred since original issuance of the bonds are counted.

(3) Refunded bonds must be redeemed (i.e., called in such a manner that no further interest accrues on the bonds) no later than the earlier of the date the refunded bonds may be redeemed at par or at a premium of 3 percent or less;

(4) Any temporary period during which unlimited arbitrage profits may be earned on the refunding bonds expires 30 days after the date of issuance, and for the refunded bonds, no later than the date of issuance of the advance refunding bonds; and

(5) Advance refunding bonds are subject to the unified State volume limitation provided by the bill to the extent of amounts attributable to any nongovernmental use of the refunded bonds that exceeded $1 million.[69]

d. Restriction on early issuance of bonds

The bill includes new rules to prevent the early issuance of bonds. Under these rules, an amount equal to at least five percent of bond proceeds must be expended for the governmental purpose of the borrowing within 30 days after the date the bonds are issued. Additionally, an amount equal to all bond proceeds (other than amounts invested in a reasonably required reserve or replacement fund) must be expended for that purpose within three years after the date of issuance. The Treasury Department is permitted, upon specific request of the issuer, to extend the 30-day and 3-year periods in cases where the delay in expenditures results from events not within the control of the beneficiary of the bonds or the issuer (e.g., Acts of God). Failure to comply with this restriction renders the interest on the bonds taxable, retroactive to the date of issue.

6. Modification and extension of miscellaneous restrictions applicable to bonds for nongovernmental persons

Several rules in the Code that establish criteria and standards for use of the proceeds of certain types of bonds on which interest is tax-exempt have been modified, and/or extended to all or most such bonds for the use of nongovernmental persons. Additionally, certain present-law restrictions have been repealed.

a. Application of bond proceeds to purpose of borrowing

The bill extends to all nonessential function bonds a present-law qualified mortgage bond requirement that all net proceeds of the issue be used for the exempt purpose of the borrowing. Net proceeds are defined as gross proceeds of the issue less amounts used to pay issuance costs and amounts invested in a reasonably required reserve or replacement fund. This provision replaces the present-law rule that only 90 percent of IDB and qualified veterans' mortgage bond proceeds must be used for the exempt purpose for which the bonds are issued (for IDBs) or for mortgage loans to veterans for owner-occupied housing (for qualified veterans' mortgage bonds). Similarly, it replaces the present-law student loan bond rule permitting use of less than a major portion of bond proceeds for purposes other than making student loans.

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[69] In the case of a second advance refunding of an issue, this nongovernmental use portion is determined by reference to the original bond issue, including bonds issued prior to 1986.

If bonds in excess of those actually required for the exempt purpose of the borrowing (plus reasonable issuance costs and reserve fund amounts described above) are issued (e.g., due to cost overruns), the committee intends that an amount of the issue equal to such excess must be retired within 30 days after acquisition of the property financed by the bonds. For a construction project, such excess bonds must be retired within 30 days after construction of the bond-financed property is more than 90 percent completed. In the case of an issue the proceeds of which are to be used both for acquisition and construction, proceeds must be allocated to each purpose of the borrowing at the time of issuance, with any excess amounts being used to retire bonds accordingly. The committee intends that the Treasury Department may adopt regulations governing such partial redemptions. Among other provisions, these regulations may permit issuers to redeem bonds with a portion of the proceeds of an issue only when the amount required to be redeemed exceeds a *de minimis* amount, determined either in absolute terms or in relation to the amount of the issue.

The committee understands that, in certain cases, statements (i.e., accounts payable) may not have been received in the normal course of business within 30 days after construction is more than 90 percent completed. The committee intends that where undue hardship otherwise would result, the Treasury Department may upon application by the issuer permit retention of bond proceeds in an amount not exceeding these accounts payable until the amounts may be ascertained with certainty and paid at the earliest date after being so ascertained. For purposes of this rule, so-called "retainage" is not treated as an unascertained amount payment of which may be delayed. Any unreasonable delay in payment of all accounts payable accompanied by a failure to redeem excess bonds renders the interest taxable from the date of issue.

The committee intends further that funds derived from other sources be treated as expended first in determining whether bond proceeds are applied to the exempt purpose of the borrowing. For example, if the actual cost of a residential rental project were determined to be $50 million, $5 million of which was to be financed with equity contributions, and if $50 million of bonds had been issued, $5 million of bonds would be required to be redeemed as not expended for the exempt purpose of the borrowing.

b. Determination of facility eligible for tax-exempt financing

The "functionally related and subordinate" standard that applies to IDBs under present law is repealed. Thus, in general, only those exempt facilities specifically described in the Code may be financed with bonds on which the interest is tax-exempt. A more complete description of what comprises an exempt facility is included under the description of each type of facility for which such exempt-facility bonds may be issued.

c. Relationship of bond maturity to life of assets

The bill extends to all nonessential function bonds (other than mortgage subsidy bonds and student loan bonds) the present-law rule that the weighted average maturity of IDB-financed property

not exceed the reasonably expected economic life of the property financed by the bonds by more than 20 percent.

d. Restriction on bond-financing for land and existing property

The present-law restrictions on the use of bond proceeds for acquisition of land and existing property also are extended to all nonessential function bonds, other than mortgage subsidy bonds, student loan bonds, and qualified redevelopment bonds.

e. Substantial user restriction

The rule under which interest on IDBs is taxable during any period when bonds are held by a substantial user of the financed facilities (or a related party) is extended to all nonessential function bonds, other than qualified mortgage bonds, qualified veterans' mortgage bonds, and qualified student loan bonds.

f. Public hearing and approval or voter referendum requirement

The present-law public approval requirements for IDBs are extended to all nonessential function bonds. As was provided when this requirement was enacted in 1982, a public hearing and approval by an authorized elected representative is not required for issues solely to refund a prior issue, provided the original issue was approved by the appropriate elected official following such a hearing. This exception does not apply, however, in the case of refunding bonds that will mature after the date on which the bonds to be refunded mature.

7. Change in use of facilities financed with nonessential function bonds

Under present law, interest on bonds may become taxable, either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur. The bill provides, that in addition to any loss of tax-exemption provided under present law, certain expenditures by persons using property financed with nonessential function bonds are nondeductible for Federal income tax purposes in certain circumstances.[70] Under this provision, interest (including the interest element of user fees) becomes nondeductible if property financed with the proceeds of these bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed.[71] The interest or other user charges are nondeductible, effective from the first day of the year in which the change of use occurs and continue to be nondeductible until the date on which the property again is used in the use for which the bonds were issued, or the date on which the bonds are redeemed, if earlier.

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[70] These additional restrictions do not apply to property financed with essential function bonds; however, those bonds remain subject to all present-law rules under which the bond interest may become taxable.

[71] This requirement applies throughout the prescribed qualified project period in the case of projects for residential rental property financed with exempt-facility bonds.

a. Governmentally owned property

If the use of governmentally owned bond-financed property changes from a use qualifying for tax-exempt financing to a nonqualified use and a governmental unit continues to own the property, a portion of any rent or other user fee paid by the nongovernmental person using the property in the nonqualified use is nondeductible.

The nondeductible portion is an amount of rent or other user fees equivalent to the interest payments on that portion of the bonds attributable to the portion of the facility used in a nonqualified use. For example, if a governmentally owned airport terminal were converted to an office or retail complex, each nongovernmental user of the converted property would be denied deductions for rent and other user fees with respect to the property, to the extent of the interest payments on an allocable portion of the bonds. If the allocable bond interest payments exceed otherwise deductible any rent or other user charges, the full amount of those deductions is denied.

If bond-financed property is required to be governmentally owned, but ceases to be, interest (including the portion of any rent or other user charges that is treated as interest for Federal income tax purposes) paid by the new owner with respect to the property is nondeductible.

b. Facilities (other than owner-occupied housing) owned by nongovernmental persons

If nongovernmentally owned bond-financed facilities are converted to a use not qualifying for such tax-exempt financing, interest on loans (including the portion of certain user fees that is equivalent to interest) financed with bond proceeds becomes nondeductible. This restriction applies in the case of a change in ownership accompanied by a change in use as well as a change in use where the same person continues to own the property for Federal income tax purposes.[72]

The bill provides a special rule for multifamily residential rental projects that fail to meet the 20 or 25 percent set-aside requirements applicable to such projects, or which otherwise cease to be used in a manner qualifying for tax-exempt financing. Under this special rule, the owners of the project are denied interest deductions with respect to bond-financed loans. However, as under the present-law rules on loss of tax-exemption, if post-issuance noncompliance is corrected within a specified period after it is discovered or reasonably should have been discovered, there is no loss of deductions. (*See*, the section on exempt-facility bonds for multifamily residential rental property, above, for a more complete discussion of this exception.)

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[72] A change in use of property financed with small-issue bonds is deemed to occur if post-issuance capital expenditures test under the $10 million small-issue size limitation is violated. Similarly, a change in use to a use specifically prohibited under the Code results in application of these penalties to facilities located on land with respect to which qualified redevelopment bond financing was provided.

c. Mortgage bond-financed housing

If a residence financed with qualified mortgage bonds or qualified veterans' mortgage bonds ceases to be the principal residence of at least one of the mortgagors for a continuous period of 1 year or more, the mortgagors are denied a deduction for interest paid with respect to the bond-financed mortgage loan on the residence. For purposes of these rules, the term principal residence has the same meaning as under section 1034 of the Code (regarding nonrecognition of gain on the sale of a principal residence).

The Treasury Department is authorized to waive this penalty in cases where undue hardship otherwise would result and the noncompliance arises from circumstances beyond the control of the mortgagors (e.g., a residence occupied by minor children of a deceased mortgagor).

The committee further is aware that certain housing comprised of fewer than five units, one of which is occupied by the owner, is treated as single-family housing under the qualified mortgage bond rules. In the case of such housing, whether the owner uses the property as his or her principal residence is determined by reference to use of the owner-occupied unit (or units).

d. Section 501(c)(3) organization bonds

If the use of property financed with section 501(c)(3) organization bonds changes to a use not qualified for such financing, the section 501(c)(3) organization benefiting from the bonds is treated as using the property in an unrelated trade or business (*see*, sec. 511) from the first day of the year in which the change in use occurs. Interest on the bond-financed loans is treated as incurred in that unrelated trade or business and is nondeductible against any income of the business.

In the case of a change in ownership of section 501(c)(3) property (other than a transfer to a qualifying governmental unit or another section 501(c)(3) organization), the new owner of the property is denied deductions for interest (including all amounts treated as interest for Federal income tax purposes) incurred in connection with the acquisition of the property.

e. Proportionate disallowance in the case of partial change in use

The Treasury Department is authorized to prescribe regulations for allocating interest on bond-financed loans in the case of a change in use (or ownership) of only a portion of a facility (or a portion of the facilities financed by an issue). In the case of partial changes in use (including a change in ownership) where an interest element is imputed as a portion of another user fee (e.g., rent), the maximum amount treated as nondeductible will be the amount of the rent or other user fee. In general, the committee anticipates that these regulations will provide that interest is allocated proportionately to all users of the facility based upon factors such as relative cost, floor space occupied, relative rental value, or another comparable method. In making this allocation, each user (owner) is treated as the sole user (owner) of all common elements of a facility.

8. Ownership of and cost recovery deductions for bond-financed property

a. Ownership requirements

General rule

Unless a specific exception is provided, facilities financed with nonessential function bonds are required to be owned for Federal income tax purposes by (or on behalf of) a qualified governmental unit. Tax ownership for this purpose is determined under general Code rules.[73]

In general, for Federal income tax purposes, the owner of property is required to possess meaningful burdens and benefits of ownership. For example, where property is leased, the lessor has to suffer or benefit from fluctuations in the value of the property, in order to be treated as the owner for tax purposes. Thus, lease treatment may be denied, and the lessee treated as the owner, where (e.g.) the lessee has the option to obtain title to the property at the end of the lease term for a price that is nominal in relation to the value of the property at the time the option may be exercised, or for a price that is relatively small compared with total lease payments. A lessee also may be treated as tax owner in certain situations where the lessor has a contractual right to require the lessee to purchase the property at the end of the lease. In determining tax ownership of property, the form of a transaction is not disregarded simply because tax considerations are a significant motive, as long as the transaction also has a *bona fide* business purpose and the person claiming tax ownership has significant burdens and benefits of ownership. (See, e.g., *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978).)

Although the governmental ownership requirement is satisfied where the property is owned on behalf of a governmental unit, the committee intends that the Treasury Department, in prescribing regulations, treat this requirement as satisfied only if ownership by the authority is in the nature of ownership by the governmental unit.

Exceptions

Exempt-facility bonds used to finance sewage disposal facilities, solid waste disposal facilities, and multifamily residential rental housing projects and qualified redevelopment bonds are exempt from the governmental ownership requirement. The requirement also does not apply to small-issue bonds or to housing financed with qualified mortgage bonds and qualified veterans' mortgage bonds.

Facilities financed with section 501(c)(3) organization bonds must be owned by the section 501(c)(3) organization using the property in its exempt activities or by a qualified governmental unit. As with other bond-financed property, ownership of these facilities is determined using general Federal income tax concepts.

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[73] The present-law rule regarding governmental ownership for certain airport, dock and wharf, and mass commuting facilities pursuant to which property is not treated as owned by a nongovernmental user if the user makes an irrevocable election to forego cost recovery deductions and the investment tax credit with respect to the property, is repealed by the bill.

b. Cost recovery deductions

The bill provides that bond-financed property for which nongovernmental ownership is permitted generally is not eligible for full cost recovery deductions to the extent that the property is financed with tax-exempt bonds. This limitation applies both to the first owner of the property and to any subsequent owners who acquire the property while the bonds (including any refunding issues) are outstanding.

Bond-financed property generally

Costs of property financed with tax-exempt bonds generally is recovered over extended recovery periods, using the straight line method. Costs of bond-financed personal property are recovered over the period prescribed for the next highest class of property, using the straight-line recovery method. For example, the cost of class 3 (7-year) property that is financed with tax-exempt bonds is recovered over a 10-year period (the period generally for class 4 property), using the straight-line method. Except in the case of multifamily residential rental property, the costs of bond-financed real property (class 10 property under the new system) is recovered using a 40-year recovery period and the straight-line method.

Multifamily residential rental property

The bill provides special, more liberal depreciation rules for multifamily residential rental property. Under these rules, costs of multifamily residential rental property eligible for bond financing qualifies for a 30-year recovery period and a 200 percent declining balance method, switching to the straight-line method in the later years. Additionally, costs of multifamily residential rental property in which 40 percent or more of units are occupied by families having incomes of 60 percent or less of the area median income may be recovered over a 20-year period, using the 200 percent declining balance method.

9. Information reporting for all bonds

The bill extends to all bonds on which interest is tax-exempt information reporting requirements similar to those that apply under present law to IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, and section 501(c)(3) organization bonds. In general, the information required to be reported to the Treasury Department is the same as required under present law. The committee recognizes, however, that certain information required under present law with respect to IDBs and mortgage bonds will be inapplicable in the case of bonds for general government operations because governmental bonds are not issued exclusively to finance specific facilities. The bill, therefore, authorizes the Treasury to vary the specific information that is required with respect to facility, and non-facility, bonds.

Effective Dates

Essential function bonds

The amendments to the definition of essential function (i.e., governmental) bond are effective for bonds issued after December 31, 1985. A transitional exception is provided for bonds (other than refunding bonds) with respect to facilities—

(1) the original use of which commences with the taxpayer and the construction (including reconstruction or rehabilitation) of which began before September 26, 1985, and was completed on or after that date;

(2) the original use of which commences with the taxpayer and with respect to which a binding contract to incur significant expenditures for construction (including reconstruction or rehabilitation) of facilities financed with the bonds was entered into before September 26, 1985, was binding at all times thereafter, and part or all of such expenditures were incurred on or after that date; or

(3) acquired after September 25, 1985, pursuant to a binding contract entered into on or before that date and that is binding at all times after September 25, 1985.

Bonds eligible for this transitional exception are bonds that, under present law, are not IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, bonds for section 501(c)(3) organizations, student loan bonds, private loan bonds, or non-Code bonds comparable to any of the foregoing, and which also are nonessential function bonds under the bill.

Additionally, this transitional exception applies only to bonds for facilities for which the bond financing in question was approved by a governmental unit (or by voter referendum) before September 26, 1985. Governmental approval for this purpose includes approval by means of an inducement resolution or, if the governmental unit does not generally adopt inducement resolutions for the type of bond concerned, other comparable approval.

For purposes of the binding contract rule, significant expenditures means expenditures in excess of 10 percent of the reasonably anticipated cost of the facilities.

Whether or not an arrangement constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed before September 26, 1985, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of articles and also grants an option to purchase additional articles, the contract is binding only to the extent of the articles that must be purchased.

A contract may be considered binding on a person even though (1) the contract contains conditions the occurrence of which are under the control of a person not a party to the contract, or (2) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract that was binding on September 25, 1985, will not be considered binding at all times thereafter if it is modified (other

than as described in (2) above) after that date. Additionally, for purposes of the binding contract exception, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the contract is delivered rather than the due date of each installment.

The bill also provides a transitional exception with respect to certain current refunding bonds.[74] Refundings qualifying for this exception[75] are refundings of bonds (1) that were issued before January 1, 1986 (including a series of refundings where the original bond was issued before that date), and (2) that are essential function bonds under present law but do not qualify as such under the bill. Refunding bonds qualify under this transitional exception only if—

(1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, and

(2) the refunding bonds (or series of refundings) do not have a maturity date later than the date which is the later of (a) 120 percent of the economic life of the property identified as being financed with the refunded bonds (or in the case of a series of refundings, the original bonds) when issued, or (b) 17 years after issuance of the refunded (original) bonds.

Exceptions for certain nonessential function bonds

Except as described below in the discussion of each specific provision, the remaining provisions affecting tax-exempt bonds are effective for all bonds issued after December 31, 1985. Transitional exceptions are provided to many of these effective dates under circumstances similar to those described in the discussion on essential function bonds, above. For purposes of these transition rules, the determination of whether original use commences with the taxpayer; of whether construction (including reconstruction or rehabilitation) or acquisition, began before (and was completed on or after) a specified date; of whether significant expenditures were made; and, of whether a binding contract existed (and pursuant to which expenditures were made after a specified date) is to be made in the same manner as under those provisions. Additionally, the determination of whether a facility is described in a properly adopted inducement resolution (or other comparable approval) is to be made in the same manner as described above.

Tax exemption for exempt-facility bonds

The provisions relating to exempt-facility bonds are effective for bonds issued after December 31, 1985. These provisions include the termination of certain activities for which exempt-activity IDBs (and industrial park IDBs) may be issued, and the amendments to the conditions for exemption for bonds for certain continued exempt facilities (formerly exempt-activity IDBs, including airports, docks and wharves, water-furnishing facilities, sewage and solid

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[74] Advance refunding bonds, as defined under the bill, may not be issued under this transitional exception.

[75] This rule does not change the present-law rules under which various types of bonds that were eliminated or restricted under the Deficit Reduction Act of 1984 may not be refunded.

waste disposal facilities, and multifamily residential rental property).

A transitional exception from the new rules for exempt-facility bonds is provided for bonds (other than refunding bonds) that may be issued under the present IDB rules, but which may not be issued under the bill. This transitional exception applies to bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation) or binding contract rules described in the discussion of effective dates for the new rules on essential function bonds are satisfied.

A second transitional exception to the exempt-facility bond provisions applies in the case of certain current refunding bonds. This exception applies to refundings (including a series of refundings) of bonds issued before January 1, 1986, which bonds qualify for tax-exemption under present law, but would not so qualify under the bill, provided that the rules of the transitional exception for current refundings of certain essential function bonds (described above) are satisfied.

Qualified mortgage bonds and qualified veterans' mortgage bonds

The amendments to the qualified mortgage bond and qualified veterans' mortgage bond provisions apply to such bonds issued after December 31, 1985.[76] Current refundings of qualified mortgage bonds and qualified veterans' mortgage bonds, which refunded bonds are issued before January 1, 1986, are not subject to the new rules provided the maturity date of the refunding bonds is not later than 32 years after the date the refunded bonds (or in the case of a series of refundings, the original bonds) were issued.

The amendments to the MCC provisions apply to credits issued using exchanged bond authority for 1986 and later years.

Qualified small-issue bonds

The repeal of the present-law sunset dates for small-issue bonds (formerly small-issue IDBs) is effective on the date of enactment.

Section 501(c)(3) organization bonds

The provisions regarding section 501(c)(3) organization bonds are effective generally for bonds issued after December 31, 1985. These provisions include the restrictions on use of bond-financed facilities by persons other than section 501(c)(3) organizations, the $150 million limitation with respect to nonhospital bonds, and the ownership and operation rules with respect to bond-financed facilities.

A transitional exception is provided for section 501(c)(3) organizations (other than refunding bonds) provided the commencement of construction (including reconstruction or rehabilitation) or binding contract rules described in the discussion of effective dates for the new rules for essential function bonds are satisfied.

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[76] Mortgage loans made after December 31, 1985, with the proceeds of bonds issued on or before that date, are not affected. *But see*, the new rules on changes in use of bond-financed property; all mortgage loans financed after December 31, 1985, are subject to those rules regardless of when the bonds are issued.

A second transitional exception to these provisions applies in the case of certain current refunding bonds. This exception applies to such refundings (including a series of refundings) of bonds issued before January 1, 1986, which bonds qualify for tax-exemption under present-law but do not qualify under the bill, provided that the rules of the transitional exception for current refundings of certain essential function bonds (described above) are satisfied.

Certain bonds issued prior to January 1, 1986, as well as bonds (other than certain current refunding bonds) covered by a transitional exception, are counted toward the $150 million limitation with respect to nonhospital section 501(c)(3) organization bonds. (*See*, the discussion of that provision under *Explanation of Provisions*, above.)

Qualified redevelopment bonds

The provisions regarding tax-exemption for interest on qualified redevelopment bonds applies to all such bonds issued after December 31, 1985.

Unified State volume limitation

General rules

Except as specifically provided below, the unified State volume limitation applies to all bonds issued after December 31, 1985. An exception is included in the substantive rules for this limitation which exempts current refundings of bonds otherwise subject to this limitation if the amount of the refunding bonds does not exceed the outstanding amount of refunded bonds and the maturity of the refunded bonds is not extended beyond certain limits. Advance refundings, where permitted under the bill, are subject to the unified volume limitation.

The bill includes two general transitional exceptions under which bonds issued after December 31, 1985, are not subject to the unified volume limitation. Both of these exceptions require that the bonds be issued with respect to facilities satisfying the commencement of construction or binding contract rules described under the discussion of the effective dates for the new rules on essential function bonds.

If either or both of the two conditions described above is satisfied, bonds that are not subject to a State volume limitation under present law (e.g., bonds for multifamily residential rental property, section 501(c)(3) organization bonds, and the nongovernmental portion of governmental bonds) are not subject to the new unified State volume limitation even if issued after December 31, 1985.

If either or both of the two conditions described above is satisfied, bonds that are subject to a State volume limitation under present law (i.e., most other IDBs, all student loan bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds), and that are issued after December 31, 1985, are not subject to the new unified State volume limitation if the bonds are issued pursuant to a carryforward election allowed under the current State volume limitation, and that carryforward election was filed with the Treasury Department on or before October 31, 1985. (Carryforward elections

of 1984 bond authority are recognized for this purpose if those elections were made timely, i.e., by February 25, 1985.)

The committee is aware that carryforward elections may have been made with respect to only a portion of the bond authority required for a project. Bonds in excess of the amounts allocated in carryforward elections are subject to the new unified volume limitation. Bonds subject to volume limitations and for which carryforward elections are not allowed under present law (e.g., qualified mortgage bonds, qualified veterans' mortgage bonds, and small-issue bonds) are subject to the new unified volume limitation if issued after December 31, 1985.

Special rule for certain solid waste disposal facilities

The bill includes a special transitional exception from the new unified volume limitation for bonds for certain solid waste disposal facilities satisfying the following conditions—

(1) Bonds for the facility are issued pursuant to a carryforward election of 1984 bond authority that was filed before February 26, 1985, or of 1985 bond authority filed before January 1, 1986;

(2) The facilities qualify for present-law depreciation and investment tax credit under either the general binding contract rule for those provisions, or the special rules for solid waste disposal facilities—

(a) with respect to which a service contract is entered into before January 1, 1986, or

(b) with respect to which the service recipient or a governmental unit (or a related party to either) has made a financial commitment to the project equal to or exceeding $200,000.

Governmentally owned facilities qualify for this special exception if the facilities would qualify for present-law depreciation and investment credit if they were nongovernmentally owned.

Arbitrage restrictions

The amendments to the arbitrage restrictions, including but not limited to the arbitrage rebate requirement, the restriction on investment in nonpurpose bonds, and the restrictions on early issuance apply to all bonds issued after December 31, 1985.

The restrictions on advance refundings apply to all advance refunding bonds issued after December 31, 1985, including such refundings of bonds issued before 1986. As discussed in the *Explanation of Provisions*, only essential function bonds generally may be advance refunded after 1985. The bill includes a special transitional exception permitting advance refundings of certain section 501(c)(3) organization bonds issued before January 1, 1986. (These bonds may be advance refunded under present law.) The exception permits advance refundings of these bonds after December 31, 1985, subject to all restrictions (including the unified volume limitation) that apply to advance refundings of essential function bonds occurring after that date.

Additionally, these section 501(c)(3) organization bonds may be advance refunded only if the purpose of the refunding is to delete a covenant from the governing documents of the refunded bonds, which covenant is in conflict with a requirement of Federal law, enacted after issuance of the refunded bonds. An example of such a

covenant would be a provision in bond documents requiring activities by a hospital that, if not changed, would render the hospital ineligible for reimbursement for services as a medicare provider. The committee intends that issuers of advance refunding bonds under this transitional exception will file a statement with the Treasury Department explaining the specific change in Federal law necessitating the advance refunding at least 30 days before issuance of the advance refunding bonds.

Modification and/or extension of miscellaneous IDB restrictions

The requirement that all net proceeds of a bond issue be used for the exempt purpose of the borrowing applies to all bonds issued after December 31, 1985, as does the repeal of the functionally related and subordinate rule applicable to IDBs under present law.[77] The restriction on maturity of nongovernmental bonds, the restrictions on acquisition of land and existing property, and the public approval requirements apply to all bonds issued after December 31, 1985, including all bonds that currently are subject to those present-law restrictions.

Changes in use

The new penalties for changes in use of bond-financed property to a use not qualifying for tax-exempt financing apply to changes in use occurring after December 31, 1985, with respect to property for which financing is provided after that date. As described in the *Explanation of Provisions*, these penalties are in addition to loss of tax-exemption for bond interest, where provided under present law.

Ownership of and cost recovery deductions for bond-financed property

Ownership

The requirements related to ownership of bond-financed property apply to facilities financed with bonds issued after December 31, 1985. Exceptions are provided for property with respect to which the commencement of construction or binding contract rules described in the discussion of effective dates for the new rules on essential function bonds are satisfied.

Cost recovery deductions

The provision restricting cost recovery deductions for property financed with tax-exempt bonds applies to property placed in service after December 31, 1985, to the extent that such property is financed by the proceeds of bonds issued after September 25, 1985. However, the restrictions on cost recovery deductions do not apply to property placed in service after December 31, 1985, if the commencement of construction or binding contract rules described in the discussion of effective dates for the new rules on essential function bonds are satisfied.

For purposes of this restriction, the determination of whether a binding contract to incur significant expenditures existed before

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[77] These requirements do not apply to current refundings of bonds issued before January 1, 1986.

September 26, 1985, is made in the same manner as under the new rules on essential function bonds.

The restrictions on cost recovery deductions for bond-financed property do not apply to property placed in service after December 31, 1985, to the extent that the property is financed with tax-exempt bonds issued before September 26, 1985. Cost recovery deductions for such property may be determined, however, under the new cost recovery rules generally provided by the bill. For purposes of this exception, a refunding issue issued after September 25, 1985, generally is treated as a new issue and the taxpayer must use the slower recovery methods and periods for costs that are unrecovered on the date of the refunding issue. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required when a pre-September 26, 1985, bond issue is refunded where no significant expenditures are made with respect to the facility after December 31, 1985.

Information reporting requirement

The requirement that issuers report certain information to the Treasury Department with respect to tax-exempt bonds applies to all such bonds issued after December 31, 1985.

Certain transitional rules from the 1984 Act

Certain transitional exceptions provided in the 1984 Act are reenacted by the bill. These transitional exceptions are those exempting a specifically described project, or limited group of such projects, from one or more provisions of that Act. For example, a convention center project and certain solid waste disposal facilities for which bonds were exempted from the volume limitation imposed in the 1984 Act (if issued before 1988) receive similar transitional exceptions under the bill. For these purposes, references to the private activity bond volume limitation enacted in 1984 are treated as references to the new unified volume limitation imposed under the bill.

The bill provides generally that the transitional exceptions included in the 1984 Act are retained only if all transitioned bonds are issued before 1988. This 1988 sunset date does not apply to bonds for facilities described in section 216(b)(3) of the Tax Equity and Fiscal Responsibility Act of 1982 for which transitional exceptions also were provided under the 1984 Act.

Additional transitional exceptions

The bill also provides several transitional exceptions for specifically described facilities. Each of these additional transitional exceptions applies only to the described project or issue of bonds and is subject to a maximum dollar amount. Many of these projects are not subject to the new unified volume limitation if the bonds are issued pursuant to a carryforward of 1984 bond authority (made by February 25, 1985) or a carryforward of 1985 bond authority (made before January 1, 1986). The specific requirements of these exceptions apply to the projects described (e.g. the specific facilities such as property described in sec. 216(b)(3) of TEFRA, and the transitional rules to the 1984 Act) in lieu of the general transitional exceptions for the volume limitation (i.e., the rule that construction have

commenced or a binding contract have been entered into before September 26, 1985).

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $132 million in 1986, $395 million in 1987, $637 million in 1988, $831 million in 1989, and $1,100 million in 1990.

B. General Stock Ownership Corporations (GSOCs)

(Sec. 702 of the bill and secs. 1391-1397, 172(b), 3402(r), 1016(a) and 6039B of the Code)

Present Law

A State may establish a General Stock Ownership Corporation (GSOC) for the benefit of all of its citizens. The GSOC may borrow money to invest in business enterprises, and subsequently service and repay the loan from the cash flow from business operations and distribute the remaining cash to its shareholders.

In order to be treated as a GSOC, a corporation must meet certain statutory tests. First, the corporation must be chartered by an official act of the State legislature or by a Statewide referendum. Second, the charter must provide for the issuance of only one class of stock, issuable only to eligible individuals (who must be residents of the State and who satisfy other specified requirements), and for the issue of at least one share to each eligible individual; transfer rights are limited. Third, a GSOC must not be empowered to invest in properties acquired by it or for its benefit through the right of eminent domain. Fourth, a GSOC may not be affiliated with any other corporation; a 20-percent ownership test is used to determine affiliated status. Fifth, a GSOC must be organized after December 31, 1978, and before January 1, 1984.

A GSOC is exempt from Federal income tax, if it meets the statutory requirements and makes an appropriate election. Thus, a GSOC may serve as a conduit passing its taxable income through to shareholders who would be taxed on their daily pro rata share of the GSOC's taxable income.

Reasons for Change

No GSOC has been organized since enactment of the authorizing legislation, and the period during which a GSOC could be formed has expired.

Explanation of Provision

The provision authorizing creation of GSOCs is repealed as deadwood, effective on the date of the bill's enactment.

Revenue Effect

This provision has no revenue effect.

TITLE VIII—FINANCIAL INSTITUTIONS

A. Reserves for Bad Debts

1. Commercial Banks (sec. 801(a) of the bill and sec. 585 of the Code)

Present Law

Under present law, commercial banks[1] are allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for Federal income tax purposes. Under the reserve method, a commercial bank is entitled to a deduction equal to that amount necessary to increase the year-end bad debt reserve balance to an amount computed under either the "experience method" or the "percentage of eligible loans method."

Specific charge-off method

Under the specific charge-off method, a deduction is allowed for bad debts as the individual debt owed the commercial bank becomes either wholly or partially worthless. At such time as the debt is determined to be uncollectible in whole or in part, the amount of the debt is reduced by the uncollectible portion, and a deduction is allowed for that amount. If an amount previously charged off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection. The bad debt deduction for wholly worthless amounts that are charged off is allowable in the year in which they become worthless. Partially worthless amounts both must have become partially worthless and also must be charged off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for Federal income tax purposes.

Reserve method

In general

Under the reserve method, a reserve account is established to record an allowance against the eventuality that some of the debts may eventually prove to be uncollectible. The actual deduction for bad debts for any year is the amount which is necessary to bring the reserve for bad debts at the beginning of the taxable year, adjusted for actual bad debt experience and recoveries during the

[1] A commercial bank is defined as a domestic or foreign corporation, a substantial portion of whose business consists or receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted national banks, and who are subject by law to supervision and examination by State or Federal Authority having supervision over banking institutions (sec. 581). For the purpose of determining the deductions for bad debts, the term "commercial bank" does not include domestic building and loan associations, mutual savings banks or cooperative nonprofit mutual banks ("thrift institutions").

year, to the allowed ending balance computed under approved methods. Amounts specifically charged off or recovered are subtracted or added to the reserve which may affect the amount that may be added to the reserve for that taxable year. The maximum allowed ending balance of the reserve for bad debts can be computed under either the "bank experience method" or the "percentage of eligible loans method."

Bank experience method

The "bank experience method" (sec. 585(b)(3), permits, in essence, the maximum allowed ending balance of the reserve to be equal to the percentage of total loans outstanding which are expected to become uncollectible within the next year. Under the bank experience method, the maximum allowed ending balance is that portion of the balance of loans outstanding at the end of the year that the total bad debts in the current and five preceding taxable years (a shorter period may be used with approval of the Secretary) bears to the sum of the loans outstanding at the close of each of those years. However, the ending reserve balance need not be reduced to an amount less than the balance in the reserve at the close of the bank's base year, so long as the amount of total loans outstanding at the close of the current taxable year are at least as great as the amount of total loans outstanding at the close of the base year. If the amount of loans outstanding at the close of the current year is less than loans outstanding at the close of the base year, then the minimum reserve amount under the base year alternative is limited to a proportionate part of the base year reserve which bears the same ratio as the ratio of loans at the close of the current year bears to loans at the close of the base year. The base year is the last taxable year before the most recent adoption of the experience method.

Percentage of eligible loans method

Under the "percentage of eligible loans method" (sec. 585(b)(2)), the maximum addition to the reserve for bad debts at the close of the taxable year is an amount necessary to increase the reserve to a specified percentage of outstanding eligible loans at that time, plus an amount determined under the experience method for loans other than eligible loans. The specified percentage for taxable years beginning after 1982 is 0.6 percent.[2] Eligible loans for this purpose generally are loans incurred in the course of a bank's normal customer loan activities on which there is more than an insubstantial risk of loss.[3]

As under the experience method, commercial banks that use the percentage of eligible loans method are permitted, at a minimum, to maintain a balance in the loan loss reserve at the close of the

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[2] For taxable years beginning after 1975 but before 1982, the specified percentage, was 1.2 percent. For taxable years beginning in 1982, the specified percentage was 1.0 percent.

[3] Specifically excluded from the definition of an eligible loan are a loan to a bank; a loan to a domestic branch of a foreign corporation which would be a bank were it not a foreign corporation; a loan secured by a deposit in the lending bank or in another bank if the taxpayer bank has control over the withdrawal of such deposit; a loan to or guaranteed by the United States, a possession or instrumentality thereof, or to a State or political subdivision thereof; a loan evidenced by a security; a loan of federal funds; and commercial paper. Sec. 585(b)(4).

taxable year equal to a base-year reserve balance so long as eligible loans have not decreased from their level in the base year. For taxable years beginning after 1982, the base year is the last tax year beginning before 1983 (the last year before the rate was changed to 0.6 percent) or the last year before the bank's most recent adoption of the percentage of loans method, whichever is later. If eligible loans have decreased below their base-year level, the minimum bad debt reserve permitted the bank is reduced proportionately.[4] In addition, the maximum addition to the reserve for losses on loans under the percentage method cannot exceed the greater of either 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans at such time.

A commercial bank may switch between the experience method and the percentage of eligible loans method of determining the addition to its reserve for losses on loans from one year to another. A commercial bank need not adopt the method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of eligible loans method is scheduled to expire after 1987. For taxable years beginning after 1987, banks will be limited to the experience method in computing additions to bad debt reserves.

Determination of worthlessness

Both the specific charge-off method and the reserve method require a determination of whether a debt is worthless in whole or in part. The determination is generally the same for both methods. Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor (Treas. Regs. sec. 1.166-2(a)). A debt is not worthless merely because its collection is in doubt. So long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless. Wholly worthless bad debts may be charged off for tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed.

In addition to satisfying this factual test, partially worthless bad debts also must be charged off on the taxpayer's books in order to be charged off for tax purposes. However, a deduction for Federal income tax purposes for a partially worthless bad debt may not be taken after the year in which the debt becomes wholly worthless.

For banks and other financial institutions regulated by Federal or state authorities, worthlessness may be presumed for any debts

[4] There is a further limitation that reduces the bad debt addition when the base year loss reserve is less than the the allowable percentage of base year loans (sec. 585(b)(2)).

charged off in obedience to specific orders of such authorities. Also, if the institution has previously charged off a debt as worthless, and the regulatory authorities confirm in writing that they would have ordered such charge-off if they had audited the institution's books on the date of the charge-off, the presumption will apply (Treas. Reg. sec. 1.166-2(d)).

Reasons for Change

The committee generally believes that the reserve method of accounting for bad debts should be repealed for several reasons. First, use of the reserve method for determining losses from bad debts results in deductions being taken for tax purposes for losses that statistically occur in the future. In this regard, the reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Moreover, use of the reserve method allows deductions prior to the time that the losses actually occur and, therefore, allows deductions larger than the actual present value of the losses. Finally, the committee is concerned that many banks, particularly those who are members of large banking organizations, have used the reserve method for determining losses from bad debts to lower substantially their Federal income tax liabilities.

At the same time, the committee is concerned that the repeal of the reserve method for smaller banks may may have some potential adverse impact. The committee seeks to balance these concerns by providing for the continued availability of reserves for bad debts for smaller banks, as under present law, while requiring larger banks to compute their losses from bad debts using the specific charge-off method. The committee feels that a proper measurement of the size of a bank for this purpose is $500 million of gross assets of the group to which the individual bank belongs.

The committee bill also provides special rules that prevent the double deduction of bad debts for banks denied the use of the reserve method for computing bad debts. Under these rules, a bank can elect to either recapture the amount of their bad debt reserves into income generally over a five year period or to continue to account for the loans outstanding prior to the year of change on the reserve method under a cut-off method.

Explanation of Provision

In general

The committee bill retains present law regarding the use of reserves in computing the deduction for losses on bad debts, except in the case of "large banks." A bank is considered a "large bank" if, for the current taxable year or any taxable year beginning after December 31, 1985, the sum of the average adjusted bases of all assets of such bank exceed $500 million or, if the bank is a member of a controlled group, the sum of the adjusted bases of all assets of such group exceeds $500 million. The adjusted basis of an asset will generally be considered to be the tax basis of the asset, adjusted by those amounts allowed as adjustments to basis by section 1016. In determining the sum of the average adjusted bases of all assets of a controlled group, interests held by one member of such group in

another member of such group are to be disregarded, in order to prevent the basis of such assets from effectively being included more than once. The average adjusted basis of the assets of a bank or controlled group is determined by dividing the sum of the adjusted bases of the assets at each time during the taxable year when the bank is required to report for regulatory purposes by the number of required reports.

A controlled group as used in this provision of the bill is a controlled group of corporations described in section 1563(a)(1). For the purpose of determining the sum of the adjusted bases of the assets of a controlled group, all corporations includible in the group under the ownership tests of section 1563(a) shall be included, without regard to their status as an "excluded member" of a controlled group as a result of the application of section 1563(b)(2), and whether or not the corporation meets the definition of a commercial bank.

Recapture of bad debt reserves of "large banks"

The committee bill provides that, unless the cutoff method is elected, a bank will be treated as having initiated a change in accounting method with regard to its calculation of losses on bad debts in the first year the bank is no longer permitted to use the reserve method (the "disqualification year"). The change in method of accounting will be considered to have been made with the consent of the Secretary. A bank treated as changing its method of accounting must take into income, over a five-year period, the balance of any bad debt reserve accounts which exist on the last day of the year before the disqualification year. The amount to be taken into income for the "disqualification year" is the greater of 1/5 of the reserves on the last day of the year before the disqualification year or such greater amount as the taxpayer may designate. The amount to be taken into income in each of the 4 taxable years succeeding the disqualification year is equal to 1/4 of the reserves at the end of the year before the disqualification year which were not taken into income in the disqualification year.

The committee bill provides an election to use the cutoff method rather than take the balance of any reserve accounts into income. A bank using the cutoff method will not be considered as having changed its method of accounting. Instead, the bank will continue to use the reserve method to account for bad debt losses on loans outstanding on the last day of the taxable year before the disqualification year.

Under the cutoff method, all charge-offs and recoveries of such loans generally will be adjustments to the reserve accounts and not separate items of income and expense. However, if the charge-off of any loan would reduce the balance in any reserve account below zero, the charge-off shall be an adjustment to the reserve account only in the amount necessary to reduce the balance in such account to zero. Any charge-offs in excess of such reserve balance, and any recoveries with regard to such loans, will be items of income and expense in the year of charge-off or recovery, as if the taxpayer had always used the specific charge-off method. Under the cut-off method, no additional deductions in the disqualification

year or thereafter are allowable for additions to the reserve for bad debts.

Unless the balance of a reserve account has been reduced to zero by the adjustment required for a charged-off item, the allowable ending balance for the reserve account is computed for year end by taking into account only those debts which were outstanding on the last day of the taxable year before the disqualification year. No additional deductions may be taken for an addition to restore the reserve account to its allowable ending balance. However, income must be recognized in the amount by which the balance in any reserve account after adjustments for charge-offs and recoveries exceeds the allowable ending balance for the account.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

The revenue effect of this provision is combined with the revenue effect for thrift institutions. (See item 3, below.)

2. Thrift Institutions

(Sec. 801(b) of the bill and sec. 593 of the Code)

Present Law

In general

Under present law, taxpayers are allowed a deduction for debts which become uncollectible during the taxable year (i.e., the "specific charge-off method") or a deduction for reasonable additions to a reserve for bad debts (ie., the "reserve method"). In the case of mutual savings banks, domestic building and loan associations and cooperative banks without capital stock which are organized and operated for mutual purposes and without profit (collectively called "thrift institutions"), the reasonable addition to the reserve for bad debts is equal to the addition to the reserves for losses computed under the "experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift's assets constitute "qualified assets," the "percentage of taxable income" method.

Experience method

The experience method for thrift institutions is identical to the experience method for banks discussed in part A.1. above.

Percentage of eligible loans method

The percentage of eligible loans method used by thrift institutions is generally the same as the percentage of eligible loans method for banks discussed in part A.1., above. However, the deduction for any year cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift institution at the close of the taxable year exceeds

the sum of its surplus, undivided profits and reserves at the beginning of such year.

Percentage of taxable income method

Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[5] The statutory percentage for tax years beginning after 1978 is 40 percent.

The full 40-percent of taxable income deduction is available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets are qualified. Qualifying assets include cash; obligations and securities of governmental entities including corporations which are instrumentalities of governmental entities; obligations of State corporations organized to insure the deposits of members; loans secured by a deposit or share of a member; loans secured by residential or church real property and residential and church improvement loans; loans secured by property or for the improvement of property within an urban renewal area; loans secured by an interest in educational, health or welfare institutions or facilities; property acquired through defaulted loans on residential, church, urban development or charitable property; educational loans; and property used in the business of the association. Where the 82-percent test is not met, the statutory rate is reduced by three-fourths of one percentage point for each one percentage point of such shortfall.[6] For mutual savings banks without capital stock, the statutory rate is reduced by 1-1/2 percentage points for each percentage point that qualified assets fail to reach the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must be qualifying (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of income method.

As in the case of the percentage of eligible loans method, the deduction for any year under the percentage of income method cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift institution at the close of the taxable year exceeds the sum of its surplus, undivided profits and reserves at the beginning of such year.

A thrift institution may switch between methods of determining the addition to its loan loss reserves from one year to another. Such a change does not, however, result in a change in the balance in the reserves for loan losses at the beginning of the year in which the change occurs.

Under present law, if the deduction for bad debts for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec.

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[5] For purposes of determining the deduction under the percentage of income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift institution's own distributions from previously accumulated reserves.

[6] For example, where a thrift institution (other than a mutual savings bank) has 75 percent of its assets in qualified assets, the statutory 40-percent rate is reduced by 5-1/4 percentage points (3/4 times 7 percentage points) to 34-3/4 percent of taxable income.

291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

Distributions in excess of earnings and profits

A special recapture provision applies to reserve balances in excess of the balance computed under the experience method. When a thrift institution distributes property to its owners, other than as interest or dividends on deposits, in excess of earnings and profits accumulated in taxable years beginning after December 31, 1951, the excess is treated as a distribution from the loan loss reserves to the extent of the excess of total loan loss reserves over what the loan loss reserves would have been if computed under the experience method. When such a distribution takes place, the thrift is required to reduce its reserve by such an amount and simultaneously recognize the amount as an item of gross income. This process increases current year's earnings and profits, and causes such distributions to be taxable to the recipient as dividends in the amount of any excess distributed, rather than as a nontaxable return of capital or as capital gains.

Determination of worthlessness

The determination of worthlessness of a debt under present law is the same as for banks discussed in part A.1., above.

Reasons for Change

Since the last time that Congress has reviewed the taxation of thrift institution and other financial institutions,[7] there have been several changes in regulatory policies that have expanded the activities in which thrift institutions may engage, and at the same time encouraged other institutions to expand their activities in areas which were traditionally serviced by the thrift institutions. These changes have resulted in other financial institutions being in direct competition with thrift institutions, while present law provides significantly different tax treatment of these financial institutions.[8] Such policies are not promoted by providing a substantially lower effective tax rate for one competitor than for others.

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[7] Until 1952, thrift institutions were exempt from Federal income tax. In 1952, Congress repealed the exemption of these institutions and subjected them to the regular corporate income tax. At that time, however, these institutions were allowed a special deduction for additions to bad debt reserves which proved to be so large that thrift institutions remained virtually tax exempt.In 1962, Congress established an alternative 60-percent of taxable income deduction for bad debts. Savings and loan associations were eligible for the full deduction only if 82 percent of their assets were invested in qualifying assets. Mutual savings banks were not subjected to the 82-percent test. In 1969, Congress established the basics of present law by providing that a thrift institution could determine its deduction for bad debts under either of the methods allowed commercial banks (the "bank experience" and the percentage of eligible loans methods) as well as the alternative of the percentage of taxable income method. The 60-percent rate in place at the time of the 1969 legislation was phased down at a rate of 3 percent per year until it reached 40 percent in 1979. The requirement that a percentage of the thrift institution's assets be qualifying assets was extended to mutual savings banks in 1969.In passing the 1969 legislation, Congress was concerned that the previous bad debt reserve provisions for thrift institutions were unduly generous, allowing a much lower effective rate of tax than the average effective rate for all corporations.

[8] The effect of the present-law 40-percent deduction, in combination with the 20-percent disallowance for corporate preferences, is to provide a maximum effective tax rate of 31.28 percent to thrift institutions, while other corporations are subject to a maximum effective tax rate of 46

Continued

Accordingly, the committee believes that present law, which allows a bad debt deduction to thrift institutions equal to 40 percent of taxable income, should be substantially reduced. Nonetheless, the committee continues to believe that there should be some incentive for thrift institutions to provide residential mortgage loans.

In order to meet these objectives, the committee bill would decrease the amount of the deduction under the percentage of taxable income method and reduce the percentage of the institution's assets that must be invested in qualified assets in order to be eligible for the full deduction under that method. Under the committee bill, the deduction for loan losses under the percentage of taxable income method is limited to 5 percent of taxable income. In addition, an institution is defined as a thrift institution, and therefore eligible for the full 5-percent deduction, where at least 60 percent of its assets are "qualified assets" (including residential mortgage loans). By reducing, rather than eliminating the percentage of taxable income method for thrift institutions, the committee intends to continue to encourage such institutions to continue to hold a significant percentage of the type of assets traditionally held by thrift institutions (i.e., residential mortgage loans) which qualify the institution as a thrift institution while not providing those institutions with a significant competitive advantage over other financial institutions.

Explanation of Provision

The bill provides that thrift institutions (mutual savings banks, domestic building and loan associations and cooperative banks) will continue to be able to compute bad debt deductions using the experience method available to banks and the percentage of taxable income method. The percentage of eligible loans method will no longer be available. In the case of the percentage of taxable income method, the portion of taxable income which may be deducted as an addition to a reserve for bad debts is reduced from 40 percent to 5 percent. The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution which holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of taxable income deduction, are eliminated. Any institution meeting the definition of a thrift institution and holding at least 60 percent of its assets as qualifying assets, will be eligible for the full 5 percent of taxable income deduction. The 60-percent test applies to mutual savings banks as well as other types of thrift institutions.

Thrift institutions which claim the 5 percent of taxable income deduction allowed by the bill will not be considered as having obtained a tax preference for purposes of the 20-percent reduction of section 291. The excess of the percentage of taxable income deduction over the deduction that would have been allowable on the

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percent. The effect of continuing the 40-percent deduction and the 20-percent disallowance for corporate preferences in combination with the 36-percent maximum corporate rate in the committee bill would have been to provide a maximum tax rate of 24.48 percent to thrift institutions.

basis of actual experience will be treated as a preference item for the purpose of computing the corporate minimum tax (sec. 57). Deductions claimed using the 5 percent of taxable income method in excess of deductions computed under the experience method also will continue to be subject to recognition as income under section 593(d) (formerly sec. 593(e)) if distributed to shareholders.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

The revenue effect of this provision is combined with the revenue effect for banks, and is presented in item 3, below.

Revenue Effect of Bad Debts Reserves Provisions

The provisions in items 1 and 2 above, are estimated to increase fiscal year budget receipts by $468 million in 1986, $828 million in 1987, $712 million in 1988, $600 million in 1989, and $700 million in 1990.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations (sec. 802 of the bill and secs. 265 and 291 of the Code)

Present Law

In general

Present law (sec. 265(2)) disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from Federal income tax (tax-exempt obligations). This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations (sec. 7701(f)).[9]

Application to taxpayers generally

The Internal Revenue Service (IRS) and the courts have consistently interpreted section 265(2) to disallow an interest deduction only when a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[10] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.

In *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F. 2d 420 (7th Cir. 1968), an interest deduction was disallowed for a corporation which made short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a sufficiently direct relationship between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempt securities, that a loan would probably be required to meet ordinary, recurrent economic needs.

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[9] In addition to interest deductions, present law (sec. 265(1)) denies a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Present law also disallows deductions for certain expenses of mutual funds which pay tax-exempt dividends and for interest used to purchase or carry shares in such a fund.

[10] Legislative history indicates that Congress intended the purposes test to apply. See, e.g., S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In Rev. Proc. 72-18, 1972-1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations.[11]

Under Rev. Proc. 72-18, a deduction is disallowed only where indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman* above. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally is not disallowed for interest on an indebtedness of a personal nature (e.g., residential mortgages) or indebtedness incurred or continued in connection with the conduct of an active trade or business. Generally, a purpose to carry tax-exempt obligations will be inferred; unless rebutted by other evidence where an individual holds tax-exempt indebtedness which is not directly connected with personal expenditures or the conduct of an active trade or business.

Under Rev. Proc. 72-18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In other cases, an allocable portion of interest is disallowed, to be determined by multiplying the total interest on the indebtedness by the ratio of the average amount during the taxable year of the taxpayer's tax-exempt obligations to the average amount of the taxpayer's total assets.

Rev. Proc. 72-18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations, even when such obligations are held for resale.[12] When dealers incur or continue indebtedness for the general purpose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed. However, the disallowance rule generally does not apply where indebtedness is incurred to acquire or improve physical facilities. The revenue procedure does not specify under what circumstances, if any, a bank is to be treated as a dealer in tax-exempt obligations.

Application to financial institutions

The legislative history of section 265(2) suggests that Congress did not intend the disallowance provision to apply to the indebtedness incurred by a bank or similar financial institution to its de-

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[11] That is, those situations not covered by Rev. Proc. 70-20, 1970-2 C.B. 499, discussed below.

[12] *See, Leslie* v. *Comm'r*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the exemption of banks under the disallowance provision (discussed below) did not apply to a brokerage business.

positors.[13] The Internal Revenue Service took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61-22, 1961-2 C.B. 58, the Internal Revenue Service restated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations * * *" within the meaning of section 265."

Despite this general rule, the Internal Revenue Service has attempted to disallow interest deductions of financial institutions in certain cases. Rev. Rul. 67-260, 1967-2 C.B. 132, provided that a deduction will be disallowed when a bank issues certificates of deposit for the specific purposes of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

In Rev. Proc. 70-20, 1970-2 C.B. 499, the Internal Revenue Service issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. Rev. Proc. 70-20 provides that a deduction will not be disallowed for interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business, unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The Internal Revenue Service will ordinarily infer that a direct connection does not exist (i.e., a deduction will ordinarily be allowed) in cases involving various forms of short-term indebtedness,[14] including deposits and certificates of deposit; short-term Eurodollar deposits and borrowings; Federal funds transactions and similar interbank borrowing; repurchase agreements; and borrowing directly from the Federal Reserve to meet reserve requirements. Within these categories, unusual facts and circumstances outside of the normal course of business may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities; in these cases, a deduction will be disallowed. However, the Internal Revenue Service will not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes is to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction is not to be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practices. Types of borrowings not specifically dealt with by the revenue procedure are to be decided on a facts and circumstances basis.

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[13] *See*, S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

[14] For purposes of the revenue procedure, "short-term bank indebtedness" means indebtedness for a term not to exceed three years. A deposit for a term exceeding three years is treated as short-term when there is no restriction on withdrawal, other than loss of interest.

Additionally, Rev. Proc. 72-18, discussed above, is applicable to financial institutions in situations not dealt with in Rev. Proc. 70-20.[15]

Since the issuance of Rev. Proc. 70-20, several cases and rulings have addressed the issue of bank deposits or similar arrangements which are secured or collateralized by tax-exempt obligations. These decisions have generally refrained from applying the disallowance provision, based upon facts of those cases.

Rev. Proc. 78-34, 1978-2 C.B. 535, allowed a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The Internal Revenue Service took the position that this type of borrowing is in the nature of a demand deposit.

In *Investors Diversified Services, Inc.* v. *United States*, 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[16] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations and, therefore, allowed an interest deduction. Noting various similarities between banks and face-amount certificate companies, the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (i.e., borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of tax-exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempt securities, since only the certificate holders had the power to terminate each certificate.

Further, in *New Mexico Bancorporation* v. *Commissioner*, 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.[17]

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[15] Rev. Proc. 70-20 was modified by Rev. Proc. 83-91, 1983-2 C.B. 618, to provide that a deduction will generally not be disallowed in the case of repurchase agreements collateralized by tax-exempt securities (as well as those collaterialized by taxable obligations). This modification was in response to the decision in *New Mexico Bancorporation* v. *Commissioner*, 74 T.C. 1342 (1980) (discussed below).

[16] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Present law (sec. 265(2)) provides that interest paid on face-amount certificates by a registered face-amount certificate company shall not be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year does not exceed 15 percent of its average total assets. The *Investor Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

[17] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-

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20-percent reduction in preference items

Under a provision originally added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and modified by the Deficit Reduction Act of 1984, the amount allowable as a deduction with respect to certain financial institution preference items is reduced by 20 percent. (The original TEFRA rule provided for a 15-percent reduction.) Financial institution preference items include interest on indebtedness incurred or continued by financial institutions[18] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) establishes otherwise, the 20 percent reduction applies to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the otherwise allowable deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations during the year in question to the average adjusted basis of the taxpayer's total assets. For example, a bank which invests 25 percent of its assets in tax-exempt obligations is denied a deduction for $5,000 of each $100,000 of interest paid to its depositors during the taxable year (20 percent x $25,000 interest allocable to debt used to acquire or hold tax-exempt obligations). For purposes of this provision, interest specifically includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not formally designated as interest.

Reasons for Change

The committee believes that the present law treatment of financial institutions for purposes of the interest disallowance rule should be changed for two reasons. First, the present law rules, by allowing financial institutions to deduct interest payments regardless of tax-exempt holdings, discriminate in favor of financial institutions at the expense of other taxpayers. Second, the committee was concerned that financial institutions may drastically reduce their tax liability as a result of the present law rules. For example, under present conditions, a bank may totally eliminate its tax liabilities by investing one-third or less of its assets in tax-exempt obligations.

To correct these problems, the committee bill denies financial institutions an interest deduction in direct proportion to their tax-exempt holdings. The committee believes that this proportional disallowance rule is appropriate because of the difficulty of tracing funds within a financial institution, and the near impossibility of assessing a financial institution's "purpose" in accepting particular

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exempt obligations. The revenue procedure concerned banks that participate in a State program that requires the banks to bid for State funds and negotiate the rate of interest, and requires the State to leave such deposits for a specified period of time. The Internal Revenue Service took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations exists in such transactions under Rev. Proc. 72-18. Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 states that the disallowance provision will continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[18] The provision applies to commercial banks including U.S. branches of foreign banks, mutual savings banks, domestic building and loan associations, and cooperative banks.

deposits. The committee believes that the proportional disallowance rule will place financial institutions on approximately an equal footing with other taxpayers.

While desiring to change the present law rules, the committee was concerned about the effect of the new rules on smaller localities which depend upon local financial institutions to buy tax-exempt bonds for bona fide governmental projects. To limit any potential increased borrowing costs to such localities, the committee bill provides a three-year transitional exception, allowing up to $10 million in bonds per local issuer to be exempt from the 100 percent disallowance rule. This exception is limited to bonds for specified governmental purposes and to in-State financial institutions. The committee bill also exempts from the new disallowance rule tax-exempt obligations acquired pursuant to binding commitments entered into before September 25, 1985, by financial institutions to purchase such obligations.

Explanation of Provision

100-percent disallowance of financial institution interest allocable to tax-exempt obligations

The committee bill denies banks, thrift institutions, and other financial institutions a deduction for that portion of the taxpayer's interest expense which is allocable to tax-exempt obligations acquired after December 31, 1985. The amount of interest allocable to tax-exempt obligations generally is to be determined as it is for purposes of the 20 percent reduction in preference items under present law, after taking into account any interest disallowed under the general rules applicable to all taxpayers (sec. 265(2) of present law). Thus, a deduction is denied for that portion of a financial institution's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis (within the meaning of sec. 1016)[18a] during the year of tax-exempt obligations held by the financial institution and acquired after December 31, 1985, to (2) the average adjusted basis of all assets held by the financial institution. For example, if an average of one-third of a financial institution's assets during the year consists of tax-exempt obligations acquired in 1986 or later years, the financial institution would be denied one-third of its otherwise allowable interest deduction. This allocation rule is mandatory and cannot be rebutted by the taxpayer.

Under the committee bill, the 20 percent disallowance rule of present law continues to apply with respect to tax-exempt obligations acquired between January 1, 1983, and December 31, 1985. Thus, a financial institution is to reduce its otherwise allowable interest deduction by the sum of (1) 100 percent of interest allocable to tax-exempt obligations acquired in 1986 or later years, and (2) 20 percent of interest allocable to tax-exempt obligations acquired in calendar years 1983 through 1985, each determined under the formula above. For example, if 25 percent of a bank's assets consists of tax-exempt obligations acquired in 1986 or later years, and an

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[18a] This adjusted basis is reduced by the basis of any debt which is used to purchase or may-tax-exempt obligations under section 265(2).

additional 25 percent consists of tax-exempt obligations acquired in 1983, 1984, or 1985, the bank would be denied 30 percent of its otherwise allowable interest deduction (i.e., 25 percent attributable to obligations acquired in or after 1986, and 5 percent (.20 x 25 percent) attributable to obligations acquired in 1983-85).

Financial institutions subject to the rule include any entity which (1) accepts deposits from the public in the ordinary course of its trade or business, and (2) is subject to Federal or State supervision as a financial institution. The committee intends that this will include (but not necessarily be limited to) banks, mutual savings banks, domestic building and loan associations, and any other entities to which the present law 20-percent disallowance provision (sec. 291) applies. In addition, 100-percent the disallowance rules applies to foreign banks doing business within the United States. Interest, the deduction of which is subject to the rule, includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not such amounts are officially designated as interest.

For purposes of the rule, tax-exempt obligations include shares in regulated investment companies (i.e., mutual funds) which distribute exempt-interest dividends during the recipient's taxable year.

The committee bill specifies that, where section 263A (relating to required capitalization of preproductive expenses including interest and taxes) applies to a portion of the interest expense of a financial institution, the disallowance with respect to tax-exempt obligations is to be applied before the rules of section 263A. For example, assume that a bank has $100 million of interest expense, $25 million of which consists of construction period interest subject to section 263A, and that one-half the bank's assets consist of tax-exempt obligations acquired after 1985. The bank's $100 million interest expense would first be reduced by one-half under the disallowance rule with respect to tax-exempt obligations. Of the remaining $50 million of interest expense, $25 million would be capitalized under section 263A.

Repeal of special treatment of face-amount certificate companies

In connection with the changes above, the special rule of present law (sec. 265(2)) relating to face-amount certificate companies is repealed. These companies will therefore be subject to the disallowance rules above in the same manner as other financial institutions.

Effective Dates

This provision is generally effective with respect to obligations acquired after December 31, 1985, in taxable years ending after that date.

The following transitional exceptions are provided:

(1) Any tax-exempt obligation acquired pursuant to a direct or indirect written commitment to purchase or repurchase such obligations, which commitment was entered into before September 25, 1985, is treated as an obligation acquired before January 1, 1986. Interest allocable to such obligations also is not subject to the 100

percent disallowance rule, but is subject to the 20 percent disallowance rule contained in present law.

(2) A special rule is provided under which any qualified tax-exempt obligation acquired by a financial institution during calendar years 1986, 1987, or 1988 is treated as if acquired before January 1, 1986. Qualified tax-exempt obligations for this purpose include any bond issued during calendar years 1986, 1987, or 1988, which (1) is not a nonessential function bond, as defined in the tax-exempt bond provisions of the bill,[19] (2) is acquired by a financial institution authorized to do business in the State of the bond issuer, and (3) is designated by the issuer as either (a) a tax anticipation note with a term not exceeding 1 year (qualified tax anticipation notes), or (b) part of an issue not exceeding $3 million (including other issues having a common purpose) and issued to provide qualified project bond financing, including financing for schools, jails, municipal building improvements, and other public projects (qualified project bonds). Not more than $10 million of aggregate obligations may be designated for these purposes by any issuer during any calendar year. Additionally, the exception is limited to bonds issued by States or political subdivisions which were in existence on October 23, 1985. As in the case of the previous transitional exceptions, qualified tax-exempt obligations are not subject to the 100 percent disallowance rule in the bill; however, these obligations are subject to the 20 percent disallowance rule contained in present law.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $29 million in 1986, $61 million in 1987, $72 million in 1988, $83 million in 1989, and $95 million in 1990.

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[19] In general, nonessential function bonds include all bonds to benefit nongovernmental persons which continue to qualify for tax exemption. (*See*, Title VII, described above.) For purposes of the exception for qualified tax-exempt obligations only, qualified section 501(c)(3) organization bonds (as defined in the bill) are not treated as nonessential function bonds.

C. Special Rules for Net Operating Losses of Financial Institutions

(Sec. 803 of the bill and sec. 172 of the Code)

Present Law

Under present law, commercial banks and thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may carry net operating losses (NOLs) back to the prior ten taxable years and forward to the succeeding five taxable years. Other taxpayers may carry net operating losses back to the prior three taxable years and forward to the succeeding fifteen taxable years.

Reasons for Change

The committee believes that net operating losses incurred by financial institutions such as commercial banks and thrift institutions should be treated in the same manner as for other taxpayers.

Explanation of Provision

The committee bill repeals the special rules which permit financial institutions a ten year carryback and a five year carryforward of net operating losses. Accordingly, financial institutions are subject to the general rule allowing taxpayers to carry net operating losses back to the prior three taxable years and forward to the succeeding fifteen taxable years generally applicable to other taxpayers.

Effective Date

The provision is applicable to net operating losses of commercial banks and thrift institutions incurred in taxable years beginning on or after January 1, 1986. Net operating losses incurred in taxable years beginning before the effective date would remain subject to the rules of present law (carryback to the prior 10 taxable years and carryforward to the succeeding 5 taxable years).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

D. Repeal of Special Rules for Reorganizations of Financially Troubled Thrift Institutions

(Sec. 804 of the bill and secs. 368, 382, and 597 of the Code)

Present Law

In general

Present law provides special rules designed to provide relief to financially troubled thrift institutions. These provisions, added by the Economic Recovery Tax Act of 1981,[20] provide that the continuity of interest requirement is met if the depositors of the financially troubled thrift institution are depositors of the surviving corporation, allow the carryover of net operating losses of a financially troubled thrift institution where its depositors continue as depositors of the acquiring corporation, and exempt certain payments from the Federal Savings and Loan Insurance Corporation to financially troubled thrift institutions from income and the general basis reduction requirement of the Internal Revenue Code.

Tax-free reorganization status

Under present law, in order for a combination of two corporations to be a tax-free "reorganization" within the meaning of section 368(a), a judicially created continuity of interest rule must be satisfied. The continuity of interest rule generally requires that the shareholders of an acquired corporation retain a meaningful ownership interest in the acquiring corporation.[21] If the transaction fails to qualify as a tax-free reorganization, the acquired corporation and its shareholders may recognize gain or loss on the transaction, and the acquiring corporation generally takes a cost basis in the acquired corporation's assets. If the transaction qualifies as a tax-free reorganization, the acquired corporation and its shareholders generally recognize no gain and the acquiring corporation assumes the acquired corporation's basis.

It was unclear prior to the 1981 Act whether a merger of an insolvent thrift institution into a solvent thrift institution could comply with the "continuity of interest" rule, expecially where one of the institutions was mutually owned. For example, in Rev. Rul. 69-3, 1969-1 C.B. 103, the Internal Revenue Service ruled that a merger of a mutual savings and loan association into another mutual savings and loan association qualified as a tax-free reorganization. Nonetheless, a case decided by the Supreme Court after the 1981 Act, but relating to facts occuring prior to the 1981 Act, held that a merger of a stock savings and loan into a mutual sav-

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[20] Pub. L. 97-34, 97th Cong., 1st Sess. (1981); referred to as the "1981 Act".

[21] *See Penellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462, 468-470; Treas. Reg. secs. 1.368-1(b), 1.368-2(a).

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ings and loan failed to qualify as a tax-free reorganization. The Court held that continuity of interest did not exist because the depositors in the acquired institution (whose savings accounts were converted into accounts in the acquiring institution) received essentially cash plus an insubstantial equity interest.[22]

Under the 1981 Act, the continuity of interest requirement need not be satisfied in the case of a merger involving a thrift institution, provided certain conditions are met. First, the acquired institution must be one to which section 593 applies, namely, a savings and loan association, a cooperative bank, or a mutual bank. Second, the FSLIC or the Federal Home Loan Bank Board (FHLBB) (or, if neither has jurisdiction, an equivalent State authority) must certify that the thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. Third, substantially all of the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization (sec. 368(a)(3)(D)). The legislative history of the 1981 amendments made it clear that the provision covered all possible combinations of stock and mutual thrift institutions, including stock acquiring mutual, stock acquiring stock, mutual acquiring mutual, and mutual acquiring stock.

Net operating loss carryovers

Where a tax-free reorganization of two corporations occurs, the acquiring corporation generally succeeds to the tax attributes of the acquired corporation, including its net operating loss carryovers, subject to certain limitations in section 382. Under section 382, the ability of an acquiring corporation to succeed to the net operating loss carryovers of a corporation acquired in a tax-free reorganization is limited to the extent the owners of the acquired corporation fail to acquire stock in the acquiring corporation representing at least 20 percent of the value of the latter's stock (sec. 382(b)).

The 1981 Act provided that depositors in a thrift that has been certified as financially troubled whose deposits carry over to the acquiring corporation will be deemed to have continued an equity interest in the thrift to the extent of their deposits. Thus, any losses of the thrift are less likely to be reduced under the loss limitation provisions of section 382.

FSLIC contributions to savings and loan associations

Although contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), the basis of property normally must be reduced by such contributions (sec. 362(c)). The status of contributions from the FSLIC as either taxable income or as a contribution to capital was unclear under prior law. The 1981 Act, however, provided that certain financially troubled thrift institutions need not reduce their basis for money

[22] *Paulsen* v. *Commissioner*, 105 S. Ct. 627 (1985).

or property contributed by the FSLIC under its financial assistance program, and such amounts are not includible in income (sec. 597).

Reasons for Change

The stated purpose of the special rules in the 1981 Act relating to financially troubled thrift institutions was to provide favorable tax rules to aid those institutions, their depositors, and the institutions that insure their deposits. The committee believes that these 1981 Act rules are inconsistent with the policies of normal tax rules that otherwise would apply to those institutions. Moreover, the committee believes that these special rules are unfair since these rules provide beneficial treatment to a selected class of beneficiaries. Accordingly, the committee believes that financially troubled thrift institutions should no longer receive the preferential tax treatment accorded by the 1981 Act.

Explanation of Provision

The committee bill repeals the special provisions enacted in the 1981 Act relating to acquisitions of financially-troubled thrift institutions, and the exclusion from income and the basis reduction requirement of FSLIC payments to such thrifts.[23] Accordingly, acquisitions and reorganizations involving financially troubled thrift institutions will be subject to the generally applicable rules.

The bill also clarifies that no deduction shall be disallowed under section 265(1), relating to expenses allocable to tax-exempt income, for any amount paid or incurred by a taxpayer on the ground such amount is allocable to amounts excluded under section 597.

Effective Date

The repeal is effective for acquisitions or mergers occurring on or after January 1, 1986. The exclusion for certain FSLIC payments is repealed for payments received in taxable years beginning on or after the same date. An exception is provided, however, for payments made pursuant to an agreement entered into on or before September 26, 1985.[23]

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $408 million in 1986, $397 in 1987, $201 in 1988, $184 million in 1989, and $174 million in 1990.

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[23] A special exception from the application of the new rules under section 382 is provided for a conversion of a mutual savings and loan association holding a federal charter dated March 22, 1985, to a stock savings and loan pursuant to the rules and regulations of the Federal Home Loan Bank Board. For amendments to code sec. 382, see sec. 321 of the bill and Titie III, Part F of this report.)

E. Treatment of Losses on Deposits or Accounts in Insolvent Financial Institutions (sec. 805 of the bill and sec. 165 of the Code)

Present Law

Under present law, a loss experienced by a taxpayer with respect to a deposit in a financial institution is treated in the same manner as any other type of bad debt loss. Deduction of the loss is generally allowable only in the year in which it is determined (based on all the facts and circumstances) that there is no prospect of recovery. Unless the deposit in the financial institution was created or acquired in connection with a trade or business of the taxpayer, any loss on the deposit will be considered as a short-term capital loss (sec. 166(d)). An individual taxpayer may generally deduct short-term capital losses only to the extent of $3,000 plus his capital gains for the year (sec. 1211).

Reasons for Change

The committee believes that the circumstances surrounding deposits in financial institutions are different from the circumstances surrounding other debts owed to a taxpayer. Depositors in financial institutions often use such accounts for temporary safekeeping of funds that are needed for food, rent, and other essential items, rather than as an investment vehicle. In many cases the funds were deposited with the expectation that they could be withdrawn either on demand or after giving appropriate notice.

The committee believes that an individual should be allowed an election to deduct the loss arising from the insolvency of a financial institution at the time that the loss becomes reasonably estimable. The committee also believes that the loss may be better viewed as a casualty loss than as a short-term capital loss, and should be entitled to casualty loss treatment for tax purposes.

Explanation of Provision

The committee bill allows qualified individuals to elect to deduct losses on deposits in qualified financial institutions as casualty losses in the year in which the amount of such loss can be reasonably estimated. If a qualified taxpayer elects to treat a loss on a deposit in a qualified financial institution as a casualty loss, no deduction for the loss as a bad debt under the provisions of section 166 will be available. The election will constitute an election of a method of accounting with regard to all deposits in the same institution, and will require any loss on such other deposits to be treated in the same manner unless the permission of the Commissioner is obtained to use a different method.

A qualified individual is any individual other than an owner of one percent or more of the value of the stock of the institution in which the loss was sustained, an officer of such institution, and certain relatives and related persons to such owners and officers. Relatives of one-percent owners and officers who will not be considered as qualified individuals are siblings (whether by whole or half blood), spouses, aunts, uncles, nephews, nieces, ancestors, and lineal descendants. An individual will be considered to be a related person of a one-percent owner or officer if he would be considered a related person under the provisions of section 267(b).

A qualified financial institution is any commercial bank (as defined in sec. 581), any thrift institution (as defined in sec. 591), any insured credit union, or any institution similar to the above which is chartered and supervised under Federal or State law. A deposit for the purposes of this provision is any deposit, withdrawable certificate, or withdrawable or repurchasable share of or in a qualified financial institution.

The amount of loss to be recognized in any year under the election is intended to be the difference between the taxpayer's basis in the deposit and the amount which is a reasonable estimate of the amount that will eventually be received with regard to such deposit. It is not intended that the failure of a taxpayer to claim a loss under this provision in the year in which such loss can first be reasonably estimated will preclude the taxpayer from claiming such loss in a later year, either under this election or as a bad debt under section 166.

If a loss that has been claimed under this election is later recovered, the lesser of the amount of the recovery or the tax benefit received as a result of the election shall be included in income in the year of such recovery.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $4 million in 1986, $2 million in 1987, $2 million in 1988, $2 million in 1989, and $2 million in 1990.

TITLE IX—ACCOUNTING PROVISIONS

A. General Provisions

1. Simplified Dollar Value LIFO Method for Certain Small Businesses

(Sec. 901 of the bill and sec. 474 of the Code)

Present Law

If the production, purchase or sale of merchandise is a material income producing factor to a taxpayer, the taxpayer is required to use the accrual method of accounting and to keep inventories. Acceptable methods of accounting for inventories include specific identification, first-in first-out (FIFO), last-in first-out (LIFO), and, in certain limited circumstances, average cost.

One method of applying the LIFO method to inventories is the dollar-value method. Under the dollar-value LIFO method, the taxpayer accounts for its inventories on the basis of a pool of dollars rather than on an item-by-item basis. Each pool of dollars includes the value of a number of different types of inventory items. Generally, for wholesalers, retailers, jobbers and distributors, items of inventory are pooled by major lines, types or classes of goods. In the case of manufacturers, all inventory items which represent a natural business unit may be combined into a single pool. Similarly, taxpayers may assign inventory items to one of a number of pools determined by the similarity of the different types of items to each other. A taxpayer with average annual gross receipts of no more than $2 million for its three most recent taxable years may elect to use a single pool for all items of inventory.

The dollar-value method measures each pool of dollars in terms of the equivalent dollar value of the inventories at the time the portion of the pool of dollars was first added to the inventory account. In order to measure the pool of dollars in terms of equivalent dollar values, the use of the dollar-value LIFO method requires the development of an index which will discount present dollar values back to the equivalent dollar values of the first year the taxpayers uses the LIFO method (called the "base year"). This is normally done by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items in base year prices (the "double-extension" method). If the permission of the Secretary of the Treasury is obtained, however, the index may be developed by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items measured in the immediate prior year's prices. This computation yields an annual index component which, when applied to all prior annual

index components, creates a cumulative index which discounts present dollar values back to the equivalent dollar values of the base year (the "link-chain" method).

In place of using actual inventory prices, a taxpayer may use tables of price changes published by the Bureau of Labor Statistics as part of the "Producers Price Index" and "Consumer Price Index" publications to construct the index necessary to determine equivalent dollar values. Use of these tables requires an index specific to the taxpayer to be constructed by taking a weighted average of price changes for specific categories of inventory. A taxpayer with average annual gross receipts for its most recent three years of no more than $2 million may use 100% of the constructed index. Taxpayers with greater average annual gross receipts are limited to an index equal to 80% of the constructed index.

Reasons for Change

The LIFO method generally is considered to be an advantageous method of accounting for inventories, particularly when costs are rising. The LIFO method matches the costs of the most recent additions to inventories against sales. When costs are rising, this results in a higher measure of costs of goods sold, and consequently a lower measure of taxable income.

The committee believes, however, that the complexity and greater costs of compliance associated with the LIFO method, including the dollar-value LIFO method, have discouraged some smaller taxpayers from using the LIFO method in accounting for their inventories. The committee believes that the LIFO method should be simplified for smaller taxpayers so that the use of the method will be practical for all taxpayers.

Explanation of Provision

In general

The committee bill provides an election to certain small businesses to use a simplified dollar-value LIFO method in accounting for their inventories. The simplified dollar-value LIFO method requires inventories to be grouped into pools in accordance with the major categories of the "Producer Prices Indexes" or the "CPI Detailed Report." The change in inventory costs for the pool for the taxable year is determined by the change in the published index for the general category to which the pool relates. The computation of the ending LIFO value of the pool is then made using the dollar-value LIFO method. The indices necessary to compute the equivalent dollar values of prior years are to be developed using the link-chain method.

Eligible businesses

A taxpayer is eligible to use the simplified dollar-value LIFO method if its average annual gross receipts for its three preceeding taxable years (or for such part of the previous three years that the taxpayer has been actively engaged in a trade or business) do not exceed $5 million. In the case of a taxpayer who is a member of a controlled group, all persons who are members of the controlled

group are to be treated as a single taxpayer for the purpose of determining average annual gross receipts. A controlled group consists of all persons who would be treated as a single employer by the Treasury regulations prescribed under section 52(b).

The provision of the committee bill is a replacement for the current law rule allowing taxpayers with average annual gross receipts of $2 million or less to elect to use a single inventory pool in accounting for its inventories using the LIFO method (sec. 474 of present law). Any taxpayer who has in effect a valid election to use the single pool method of present law may continue to account for its inventories using that election, so long as the taxpayer continues to meet the requirements for that election. A taxpayer accounting for its inventories using the single pool election of section 474 of present law is not eligible to elect to use the simplified dollar-value LIFO method of the committee bill for any year in which the election under present law is effective. Under the committee bill, the election to use the single pool method of section 474 of present law may be revoked without the consent of the Secretary of the Treasury.

Making the election

A taxpayer may elect to use the simplified dollar-value LIFO method without the consent of the Secretary of the Treasury. The election is to be made at such time and in such manner as the Secretary of the Treasury may prescribe by regulations. An election to use the method applies to the year of election and to all succeeding taxable years, unless permission to change to another method is obtained from the Secretary of the Treasury, or the taxpayer becomes ineligible to use the simplified dollar-value LIFO method as a result of having exceeded $5 million of average annual gross receipts.

If the taxpayer previously has used a method of accounting for its inventories which allows the value of the inventories to be written down below cost, any amount of such writedown must be restored to income in accordance with section 472(d).

If the taxpayer makes an election to use the simplified dollar-value LIFO method, the method must be used for all the inventories of the taxpayer that are accounted for using a LIFO method.

Computation of simplified dollar-value LIFO inventories

In general.—The computation of inventory values using the simplified dollar-value LIFO method generally follows the rules currently provided for computation of inventories using the dollar-value LIFO method in Treas. Regs. sec. 1.472-8. However, the simplified dollar-value LIFO method differs from current rules with regard to the manner in which inventory items are to be pooled, the use of published indices to determine an annual index component for each pool, and the technique to be used in computing the cumulative index for a pool for any given year.

The simplified dollar-value LIFO method requires the use of multiple pools in order to avoid the construction of a weighted index specific to the taxpayer. Rather than construct such an index, the annual change in costs for the pool as a whole is measured by the change in the published index for the general category. The per-

centage change for the year in the published index for the general category determines the annual index for the pool.

The simplified dollar-value LIFO method uses the link-chain approach, rather than the double-extension approach, to compute a cumulative index for the purpose of determining equivalent dollar values in prior years.

Establishment of inventory pools.—The simplified dollar-value LIFO method requires inventory pools to be established based on either the 15 general (2 digit) categories of the "Producers Prices and Price Indexes for Commodity Groupings and Individual Items" (currently "Table 6. Producer prices and price indexes for commodity groupings and individual items, Producers Price Indexes" published monthly by the Bureau of Labor Statistics) or the 11 general categories of the "Consumer Price Index for All Urban Consumers" (currently "Table 3. Consumer Price Index for All Urban Consumers: Food expenditure categories, U.S. city average, CPI Detailer Report" and "Table 5. Consumer Price Index for All Urban Consumers: Nonfood expenditures categories, U.S. city average, CPI Detailed Report" published monthly by the Bureau of Labor Statistics) as set forth in Treas. Regs. sec. 1.472-8(e)(3)(iv).[1] Retailers using the retail method are to use the CPI categories and all other taxpayers must use the Producers Price Index categories.

Selection of index.—The taxpayer must establish which month of its taxable year it will use to measure the annual change in the index for all pools. Once the choice of month is established, another month may not be used unless advance permission to do so is granted by the Secretary of the Treasury. The annual change is measured from the established month in one calendar year to the same month in the next calendar year. Comparison of different months to measure change is not allowed. If the published index figure which the taxpayer has used to measure annual change in costs for an inventory pool is restated by the Bureau of Labor Statistics after the taxpayer has filed its return for the taxable year in question, the return shall not be filed again or amended in order to reflect the restatement. Instead, the change in costs for the pool for the next taxable year will be measured with regard to the index figure which was used to measure the change in costs for the prior taxable year as the return was filed, and not the restated value.

Rules applicable to year of change.—The first year for which the simplified dollar-value LIFO method is used will represent a new base year for the purpose of the dollar-value LIFO computation. The base year dollar value of each pool will be the portion of the beginning inventory value for such first year which is attributable to the inventory items represented by such pool.

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[1] The 11 categories in the Consumer Price Index are food and beverages; housing, maintenance and repair commodities; fuels (other than gasoline); house furnishings and housekeeping supplies; apparel commodities; private transportation (including gasoline); medical care commodities; entertainment commodities; tobacco products; toilet goods and personal care appliances; and school books and supplies. The 15 categories in the Producers Price Index are farm products; processed food and feeds; textile products and apparel; hides, skin, leather, and related products; fuels and related products and power; chemicals and allied products; rubber and plastic products; lumber and wood products; pulp, paper, and allied products; metals and metal products; machinery and equipment; furniture and household durables; nonmetalic mineral products; transportation equipment; and miscellaneous products.

The computations necessary to convert a taxpayer's inventories to the simplified dollar-value LIFO method will depend upon the method that was used to account for the inventories prior to the year of election. A taxpayer that has been using the FIFO method to value its inventories must establish base year dollar values for each of its pools by assigning the inventory items to their respective pools and combining their values. The combined values of inventory items assigned to a pool constitute the base year layer of the pool for future dollar-value LIFO computations.

A taxpayer changing to the simplified dollar-value method from a method that allows inventories to be stated at less than cost (such as the FIFO method) must restore to income any amounts by which the previous inventories were written down below cost, as required by section 472(d). The base year dollar value of the pools established for dollar-value computations will include any amounts required to be recognized as income by section 472(d).

A taxpayer that has been using a LIFO method must establish values for each of its pools expressed in base year dollars in generally the same manner as does a taxpayer that has been using the FIFO method. In order to preserve pre-existing LIFO layers, however, the entire value of the inventory is not considered as attributable to the base year as is the case for taxpayers that have been using the FIFO method. Instead, the taxpayer is required to restate the prior years' layers in values expressed in base year dollars by comparing the prices at which such goods were added to inventories and determining an index for the layer with reference to the present value of the same inventory item.

Example.—The following example shows the computations required by a taxpayer in the first year in which it uses the simplified dollar-value LIFO method. The example assumes that the taxpayer used the FIFO method to calculate inventories in prior years.

The taxpayer's inventories consist of a chemical, classified in the "Chemicals and Allied Products" general category, and a high school chemistry text book, classified in the "Pulp, Paper and Allied Products" general category. The index numbers for the "Chemicals and Allied Products" general category are 200 for the prior year (the "base year") and 220 for the current year (the "first LIFO year"). The index numbers for the "Pulp, Paper and Allied Products" general category are 142 for the prior year and 150 for the current year. In the prior year, the present dollar value of the taxpayer's ending inventory was $30,000 for the chemical and $30,000 for the textbooks. In the current year, the present dollar value of the taxpayer's ending inventory is $35,000 for the chemical and $30,000 for the textbooks.

As the two types of inventory items are classified in different general categories, the taxpayer must set up a separate dollar-value LIFO pool for each. The annual index for each pool is determined by taking one plus the percentage change in the index for the general category, as shown in the following table.

Pool	Current year index	Prior year index	Change	Percent change	Index
#1	220	200	20	0.1000	1.1000
#2	150	142	8	.0563	1.0563

For years after the first year in which the method is used, the annual index would be multiplied by the cumulative index for the prior year to determine the current cumulative index. For the first year in which the simplified dollar-value LIFO method is used, the annual index and the cumulative index are the same.

The present dollar value of the ending inventory for the current year is divided by the cumulative index to restate the ending inventory in its equivalent value in base year dollars. This amount is assigned to the appropriate LIFO inventory layers and multiplied by the cumulative index for the year to which the layer relates in order to find an indexed dollar value for that layer. The sum of the indexed dollar values for the layers is the ending LIFO inventory value for the pool. These computations, for the taxpayer's first year using the simplified dollar-value LIFO method, are shown below.

Pool #1

Current year dollar value of inventory	$35,000
Divided by index	1.100
Inventory in base year dollars	$31,818

LIFO layers	Base year dollar value	Dollar index	Indexed dollar value
Base year	$30,000	1.0000	$30,000
First LIFO Year	1,818	1.1000	2,000
Ending inventory	31,818		32,000

Pool #2

Current year dollar value of inventory	$30,000
Divided by index	1.0563
Inventory in base year dollars	$28,401

	Base year dollar value	Index	Indexed dollar value
Base year	$28,401	1.0000	$28,401
First LIFO year	0	0	0
Ending inventory	28,401		28,401

Total Ending Inventory:

Pool #1	$32,000
Pool #2	28,401
	60,401

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $211 million in 1987, $422 million in 1988, $564 million in 1989, and $697 million in 1990.

2. Limitations on the Use of the Cash Method of Accounting

(Sec. 902 of the bill and sec. 446 of the Code)

Present Law

Under present law, a taxpayer generally may elect (on its first income tax return) to use any method of accounting that clearly reflects income and that is regularly used in keeping the taxpayer's books and records (sec. 446). The latter requirement is considered satisfied even if the tax accounting method differs from that used by the taxpayer in keeping its books and records so long as sufficient records are maintained to allow reconciliation of the results obtained under the two methods.

A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business ordinarily will be regarded as clearly reflecting income.

If the method chosen by the taxpayer fails to reflect income clearly, the Internal Revenue Service may require the taxpayer to use a method meeting the statutory standard (sec. 446(d)). The Internal Revenue Service has wide discretion in determining whether a particular method of accounting should be disallowed as not clearly reflecting income. Once a method of accounting has been selected by a taxpayer, a change to a different method requires the consent of the Internal Revenue Service.

Various methods of accounting are allowed under present law, including the cash receipts and disbursements method (the "cash method"), the accrual method, certain industry specialized methods, and, within certain limitations, hybrid methods combining several approaches of these and other methods.

The cash method generally recognizes items of income when actually or constructively received and items of expense when paid. The accrual method generally recognizes an item of income when all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be established with reasonable accuracy. An item of expense is recognized when all events have occurred that establish an obligation to pay, the amount of the expense can be established with reasonable accuracy, and there has been economic performance with respect to that item.

Present law requires the use of the accrual method in certain situations. First, if the production, purchase or sale of merchandise is a material income producing factor to the taxpayer, the taxpayer is required to use the accrual method of accounting and keep inventories (sec. 471; Treas. Reg. sec. 1.471-1). Second, certain corporations

engaged in agricultural activities with gross receipts exceeding $1 million are required to use the accrual method of accounting (sec. 447).

Reasons for Change

In general

The committee believes that the cash method of accounting frequently fails to reflect accurately the economic results of a taxpayer's trade or business over a taxable year. The cash method of accounting recognizes items of income and expense based on the taxable year in which funds are received or disbursed. This may result in the recognition of income and expense items without regard to the taxable year in which the economic events giving rise to the items occurred and, therefore, generally is not in accord with generally accepted accounting principles. The cash method also produces a mismatching of income and deductions when all parties to a transaction use different methods of accounting.

Exceptions

On the other hand, the committee recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continued use by certain types of taxpayers and for certain types of activities. The committee believes that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher costs of compliance which will result if they are forced to switch from the cash method. Similarly, the committee believes that farming businesses (other than certain corporate farming businesses required to use the accrual method under present law) should be able to continue to use the cash method in order to avoid the complexities required to account for growing crops and livestock under any other acceptable method of accounting.

Finally, the committee believes that individuals, whatever the size of their activities, should be able to continue to use the cash method. Individuals, especially individuals engaged in professional activities, traditionally have used the cash method of accounting in the operation of their trades or businesses. Similarly, the committee believes that personal service corporations and entities where the income is taxed at the individual level (such as partnerships and S corporations) traditionally have used the cash method of accounting in the operation of their trades or businesses and, accordingly, should be eligible for the continued use of the cash method of accounting.

Nonaccrual of certain items unlikely to be collected

The committee is concerned that certain taxpayers will be required to accrue income from services with respect to amounts they are unlikely to collect. Where a taxpayer includes accounts receivable, which do not bear interest or a late charge in its income, accrual in income of the full sales price immediately, combined with a bad debt deduction allowed at a later time, will overstate the taxpayer's income because the present value of the bad debt deduction will be less than the present value of the accrued income. Accord-

ingly, the committee bill provides that taxpayers on the accrual method will not be required to accrue income attributable to that portion of their accounts receivable derived from the performance of services which are unlikely to be collected. The committee bill provides that this exception does not apply where the accounts receivable bear interest or a late charge because the face amount of the obligation bearing interest or late payment charges is the present value of the accrued income and, consequently, the present value of the accrued income will not exceed the present value of the later bad debt deduction.

Explanation of Provision

General rule

The committee bill provides that certain taxpayers may not use the cash method of accounting for Federal income tax purposes. The rule applies to corporations (other than S corporations) and partnerships where one of the partners is a corporation (other than an S corporation), except in certain specified cases. The rule also applies to trusts subject to tax under section 511(b) with respect to activities of the trust constituting an unrelated trade or business. The use of a hybrid method of accounting which records some, but not all, transactions using the cash method will be considered the same as the use of the cash method for these purposes. Any change from the cash method necessitated by the committee bill will be treated as a change in accounting method, initiated by the taxpayer with the approval of the Secretary of the Treasury. The committee bill does not change the rules of present law relating to what accounting methods clearly reflect income or the authority of the Secretary of the Treasury to require the use of an accounting method that clearly reflects income.

Trades or businesses allowed to continue use of the cash method

Small businesses.—The committee bill allows the continued use of the cash method of accounting by taxpayers with average annual gross receipts of $5 million or less that are allowed to use the cash method of accounting under present law. Average annual gross receipts are to be computed by dividing the sum of the gross receipts for so many of the previous three taxable years (not including the current taxable year) as the taxpayer conducted business by the number of such taxable years. For this purpose, gross receipts does not include sales returns and allowances for a taxable year. For purposes of the $5 million test, gross receipts for any taxable year of less than 12 months are annualized.

In determining whether a taxpayer has average annual gross receipts in excess of $5 million, the gross receipts of all related entities are aggregated if such entities would be treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414.

Farming businesses.—The committee bill allows the continued use of the cash method of accounting by farming businesses, other than those farming businesses which are not allowed to use the cash method of accounting under present law. A farming business is any business engaged in the growing, raising, managing, or

training of crops or livestock. In addition, a farming business includes the operation of a nursery or a sod farm. A farming business includes the raising or harvesting of Christmas trees and other ornamental trees, but does not include, the raising or harvesting of other trees, unless the trees bear fruits, nuts, or some other crop and the trees are raised or acquired for the primary purpose of exploiting such fruits, nuts, or other crop.

Individuals and qualified personal service corporations.—The committee bill allows the continued use of the cash method of accounting for entities where the incidence of taxation falls either at the individual level or on a qualified personal service corporation. Entities eligible for the exception include sole proprietorships, S corporations, qualified personal service corporations and qualifying partnerships.

A qualifying partnership is a partnership in which all of the partnership interests are held by individuals, qualified personal service corporations, S corporations, or other qualifying partnerships.

For purposes of this exception, a qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts or consulting. The ownership test is met if substantially all of the value of the outstanding stock in the corporation is owned by employees performing services for the corporation in a field satisfying the function test, retired individuals who performed services for the corporation or its predecessor(s) in such a field, the estate of such an individual, or any person who acquired its ownership interest as a result of the death of such an individual within the prior 24 months (disregarding community property laws). For the purposes of applying the ownership test, stock owned by a partnership, an S corporation or a qualified personal service corporation will be considered as owned by its partners or shareholders.

Time of accrual

The committee bill provides that in the case of the provision of personal services by an accrual basis taxpayer, the taxpayer is not required to accrue amounts earlier than when the amounts are billed by the taxpayer. For these purposes, provision of personal services does not include the provision of services of a kind typically provided by a regulated public utility or the providing of services by a bank or similar financial institution.[2]

The committee bill also modifies the economic performance test for all taxpayers receiving services to provide that, in the case of services provided by a non-employee, economic performance does not occur before the taxpayer is billed for the services.

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[2] No inference as to the proper timing for the accrual of income and expense under present law is to be drawn from the exclusion of utility services and services provided by a financial institution from the time-of-accrual rules of the committee bill. Such services are intended to be treated in the same manner as under present law.

Amount of accrual

The committee bill provides that an accrual basis taxpayer need not accrue as income any portion of amounts billed for the performance of services[3] which, on the basis of experience, it will not collect. This rule does not apply, however, if the taxpayer charges any interest or penalty for failure to make timely payment in connection with the amount billed. The offering of a discount for early payment of an amount billed will not prevent application of the rule as long as the full amount of the bill is otherwise accrued as income and the discount for early payment treated as an adjustment to income in the year such payment is made.

The amount of billings that, on the basis of experience, will not be collected is equal to the total amount billed, multiplied by a fraction whose numerator is the total amount of such receivables which were billed and determined not to be collectible within the most recent five years taxable years of the taxpayer, and whose denominator is the total of such amounts billed within the same five year period. If the taxpayer has not been in existence for the prior five taxable years, the portion of such five year period which the taxpayer has been in existence is to be used.

For example, assume that an accrual-basis taxpayer has $100,000 of receivables that have been created during the most recent five taxable years. Of the $100,000 of accounts receivable, $1,000 have been determined to be uncollectible. The amount, based on experience, which is not expected to be collected is equal to 1 percent ($1,000 divided by $100,000) of any receivable arising from the provision of services that are outstanding at close of the taxable year.

A taxpayer who has not recognized income on amounts not expected to be collected must recognize additional income in any taxable year in which payments on amounts not recognized are received. If a receivable is determined to be partially or wholly uncollectible, no portion of the loss arising as a result of such determination, that was not recognized as income at the time the receivable was created, shall be deductible.

The committee intends that the Secretary of the Treasury may provide a periodic system of accounting for billings that, on the basis of experience, will not be collected where the periodic system results in the same taxable income as would be the case were each receivable recorded separately.

Transitional rules

The committee bill treats any change from the cash method of accounting required as a result of the committee bill as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. In order to prevent items of income and expense from being included in taxable income either twice or not at all, an adjustment under section 481 is required to be made. The amount of such adjustment will be included in income over a period not to exceed five taxable years. It is expected that the concepts of Revenue Procedure 84-74, 1984-2 C.B.

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[3] For this purpose, the performace of services does not include the activities of banks and other financial institutions.

736, generally will apply to determine the actual timing of recognition of income or expense as a result of the adjustment.[4]

In the case of the business of operating a hospital, the transitional rules will apply with the section 481 adjustment amount to be included in income over a period not to exceed ten taxable years, rather than five. For the purpose of this provision, a hospital is a taxable or tax-exempt institution that—

(1) Is accredited by the Joint Commission of Accreditation of Hospitals (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found the the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH;

(2) Is primarily used to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(3) Has a requirement that every patient be under the care and supervision of a physician; and

(4) Provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times.

For the purposes of this provision, the term "hospital" does not include rest or nursing homes, daycare centers, medical school facilities, research laboratories or ambulatory care facilities.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986. The committee bill provides an exception under which taxpayers may elect to continue to report income from loans, leases, and transactions with related persons entered into before September 25, 1985, on the cash basis.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $267 million in 1986, $560 million in 1987, $596 million in 1988, $610 million in 1989, and $636 million in 1990.

3. Pledges of Installment Obligations (Sec. 903 of the bill and sec. 453C of the Code)

Present Law

In general

Under present law, gain from certain sales of property in exchange for which the seller receives deferred payments may be reported on the installment method, unless the taxpayer elects otherwise (sec. 453). Eligible sales include dispositions of personal property on the installment plan by a person who regularly sells or oth-

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[4] Under that revenue procedure, the adjustment from a change in accounting generally is included in income over a period equal to the less of the number of years the taxpayer has used the accounting method or a specified number of years.

erwise disposes of personal property on the installment plan (sec. 453A) and other dispositions of property (not including dispositions of personal property of a kind that is required to be included in the taxpayer's inventory) where at least one payment is to be received after the close of the taxable year in which the disposition occurs (sec. 453(b)(1)). The installment method may not be used where a sale results in a loss.

Under the installment method, in any taxable year, a taxpayer recognizes income resulting from a disposition of property equal to an amount that bears the same ratio to the payments received in that year that the gross profit under the contract bears to the total contract price. Payments taken into account for this purpose generally include cash or other property (including foreign currency and obligations of third parties), marketable securities, certain assumptions of liabilities, and evidences of indebtedness of the purchaser that are payable on demand or are readily tradable (Temp. Treas. Reg. sec. 15A.453-1(b)(3)).

For example, assume property that has a basis of $50,000 is sold in a transaction eligible for installment reporting. The seller receives $40,000 immediately in cash and will receive $60,000 (plus interest at the current market rate) in the next taxable year. Under the installment method, the seller recognizes $20,000 of gain immediately—$50,000/$100,000 (gross profit ratio) times $40,000 (payments received). The seller recognizes the remaining $30,000 of gain when the final payment is received--$50,000/$100,000 times $60,000.

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to either (a) the difference between the amount realized and the basis of the obligation in the case of satisfaction at other than face value or sale or exchange of the obligation, or (b) the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation in the case of any other disposition (sec. 453B). The basis of the obligation is equal to the basis of the property sold plus amounts of gain previously recognized. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[5]

Reasons for Change

The basic purpose for permitting the reporting of gain under the installment method is to tax the income from a deferred payment sale at the time that the taxpayer receives the cash from which the taxes are to be paid. The committee believes that a taxpayer who borrows against an installment obligation is not faced with the liquidity problem that installment reporting generally is intended to alleviate, at least to the extent of the amount borrowed. A taxpayer who receives the proceeds of a loan for which an installment obligation is pledged may not be situated much differently from one

[5] See, e.g., *Town and Country Food Co., Inc.* v *Commissioner*, 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc.* v. *Commissioner*, 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

who has received a like amount of cash or readily tradable obligations of the purchaser for the property; the latter taxpayer, however, could not defer the taxation of the gain from the underlying transaction attributable to such payments. Accordingly, the committee believes that the receipt of cash from the pledging of an installment obligation is an appropriate time to tax an amount equal to the gain element of the borrowed amount. On the other hand, the committee believes that pledging of installment receivables should not result in immediate taxation where either the maturity of the installment receivable or the maturity of the borrowings is relatively short.

Explanation of Provision

In general

Under the committee bill, if certain installment obligations are pledged as collateral for a loan, all or a portion of the proceeds of the loan generally are treated as a payment received on the obligation. An exception is provided to allow taxpayers to continue to use the installment method with respect to a portion of an installment obligation that has been pledged, where the potential deferral of gain attributable to such portion does not exceed 9 months. An exception also is provided for installment obligations that are pledged for indebtedness with a term not exceeding 90 days, where the pledge does not affect the same degree of "cashing out" of the obligation that would result were the obligation pledged for longer term debt.

Obligations subject to the provision

The committee bill applies to the pledge of all installment obligations, other than those installment obligations arising from the sale by any person (other than a tax shelter as defined in section 461(i)(3)) of tangible property that was a capital asset (as defined in sec. 1221) at all times during the seller's holding period (within the meaning of section 1223). For example, property that at any time during the seller's holding period was treated as being used in the seller's trade or business would be subject to the provision. On the other hand, the provision does not apply to a personal residence or vacation home that was not held for rental.

Application of the provision

Under the committee bill, if an installment obligation (including revolving credit account balances), to which the provision applies is pledged as collateral for a loan, gain generally is recognized equal to the product of the net loan proceeds[6] and the gross profit ratio applicable to that obligation. Receipt by the taxpayer of payments on the pledged installment obligation subsequent to the time of the pledge generally does not result in recognition of gain except to the extent that the gain that otherwise would be recognized on account of such payments exceeds the gain, if any, recognized as a result of any pledge of such obligation. The rule relating to nonrecognition

[6] The net proceeds are equal to the gross proceeds of the loan less any expenses of obtaining the loan.

of gain from subsequent payments applies regardless of whether such payments are used to pay any portion of the indebtedness secured by the installment obligation. Nonetheless, the total amount of gain that can be recognized on an obligation as a result of pledges and the receipt of payments can not exceed the gain that could be recognized on the obligation in the absence of the provision.

Exceptions

Nine-month exception

The provisions of the committee bill do not apply to the pledge of an obligation to the extent that payments on the obligation are due within nine months. Where installment obligations arising from sales on a revolving credit plan are pledged, the provisions of the committee bill do not apply to the extent that amounts are expected to be paid within nine months. The determination of the appropriate portion of installment obligations under a revolving credit plan eligible for this exception is to be made under Treasury regulations on the basis of statistical sampling of the taxpayer's revolving credit accounts, applying payments to the earliest outstanding charges.

For purposes of applying the exception (both in the case of revolving credit and other installment receivables), if the face amount of the installment obligation exceeds the net loan proceeds, such proceeds are allocated on a pro rata basis between the portion of the installment obligation that is due within nine months and the portion that is due after nine months. For example, assume property is sold in exchange for an installment obligation to which the provision applies. The stated principal amount of the obligation, which bears interest at a fair market rate, is $100,000, of which $9,000 (plus interest) is due within the first nine months. The obligation is pledged for a loan the net proceeds of which are $50,000. The $50,000 proceeds are allocated $45,500 (i.e., $91,000/$100,000 times $50,000) to the portion of the installment obligation that is due after nine months and $4,500 to the portion of the obligation that is due within nine months. Accordingly, the taxpayer is treated as having received a payment of $45,500 on the installment obligation as a result of the pledge.

Under the committee bill, gain is recognized on payments received subsequent to a pledge to the extent such payments do not exceed the portion of the obligation that is payable within nine months. The receipt of subsequent payments on the pledged obligation in excess of the portion of the obligation that is due within nine months does not result in the recognition of additional gain except to the extent that gain attributable to such payments exceeds the gain recognized on account of previous pledges of the obligation. Thus, in the above example, the receipt of the first $9,000 of payments on the obligation result in recognition of additional gain to the seller. The seller would not then recognize additional gain until more than an additional $45,500 in payments are received. Similar rules apply to revolving credit receivables.

General lien exception

The provisions of the committee bill also do not apply if an installment obligation is pledged merely pursuant to a general lien on all of the borrower's assets securing amounts borrowed from an unrelated financial institution if at least 50 percent of the borrower's assets (by value) are used in an active trade or business of the taxpayer. For this purpose, the value of any asset is reduced by the amount of any indebtedness that is secured by such asset, or to which such asset is subject. For example, assume that a taxpayer has outstanding a loan that is secured by a mortgage on specific trade or business assets of the taxpayer; the taxpayer also has borrowed amounts from an unrelated financial institution, which amounts are secured by a general lien on all of the taxpayer's assets. The mortgage has priority over the general lien with respect to the specifically mortgaged assets. In this situation, the value of the taxpayer's trade or business assets (and total assets) is reduced by the amount of the mortgage for purposes of determining whether at least 50 percent of the taxpayer's assets are used in an active trade or business.

The value of assets generally is their fair market value at the time the borrowing occurs. However, the committee intends that the Treasury Department may prescribe regulations that might permit taxpayers to use adjusted basis or book value as an alternative to fair market value, and that might permit or require fair market value (or appropriate substitute) to be determined as of a time other than the time of the borrowing, or on the basis of an average over a reasonable period of time.

The committee intends that the leasing of assets is not to be considered an active trade or business for this purpose. The amount of assets used in an active trade or business includes an amount of working capital not in excess of the reasonable needs of the business. Nonetheless, the committee intends that, except for such reasonable amounts of working capital, under no circumstances may passive assets (including installment receivables and leases) of the taxpayer be treated as assets used in the taxpayer's active trade or business.

The committee intends that the Treasury Department will specify in regulations how the 50-percent test is to be applied to affiliated groups of corporations and other related entities. For example, the committee intends that in determining whether 50 percent or more of the borrower's assets consist of active trade or business assets, assets held in controlled subsidiaries (within the meaning of section 1504(a)(2)) would be included if the rights of the lender are substantially the economic equivalent of what the lender's rights would be if the assets and liabilities of the subsidiaries were held directly by the company holding the receivables. It is expected that the Treasury Department will issue regulations indicating those situations under which the lender's rights would be substantially equivalent. The committee believes that if, for example, the parent and the controlled subsidiary each have guaranteed each other's debt in a manner such that no creditor of either the parent or the controlled subsidiary has a priority with respect to the installment

receivables, then the lender's rights in this situation may be considered substantially the economic equivalent.

90-day debt exception

Further, the provisions of the committee bill do not apply to the pledge of an installment obligation in connection with any indebtedness the terms of which require payment in full within 90 days of its issuance, provided the indebtedness is not extended, refinanced, or otherwise replaced during the 45-day period beginning on the day such indebtedness is repaid. The committee intends that indebtedness may be considered to be extended, refinanced, or otherwise replaced without regard to the identity of the new lender or the terms of the indebtedness.

Indirect pledges

The committee bill provides that an installment obligation shall be treated as pledged as security for indebtedness if it is reasonable to expect that the lender took into account payments on the installment obligation as a source for any portion of the payments required on the indebtedness. The committee expects that the Treasury Department will issue regulations describing situations where installment obligations shall be deemed to have been pledged under this rule, including regulations that provide presumptions and safe harbors where appropriate. The committee intends, for example, that where a parent corporation has a wholly owned subsidiary that holds primarily installment obligations, and the parent pledges the stock of the subsidiary as collateral for a loan, the payments on the installment obligation may be treated as a source of payments required on the indebtedness.[7] Similarly, the lender may be treated as relying on the installment obligations as a source of payment where a subsidiary holding primarily installment obligations borrows on an unsecured basis.

For purposes of this rule, the committee intends that payments on the installment obligations will not be treated as having been taken into account as a source of the payments on the indebtedness where more than 50 percent of the borrower's assets are used in an active trade or business, (as if the borrowing qualified under a rule similar to the rules relating to general liens.

In applying the indirect pledge rule, if the facts clearly indicate that the lender considered other assets as the source of payment, then the taxpayer's installment obligations would not be treated as having been indirectly pledged.[8] For example, a taxpayer whose assets consist of installment receivables, other passive assets, and a factory (and more than 50 percent of whose assets are not used in an active business assets), would not be treated as having indirectly pledged its installment receivables if the borrowing is secured only

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[7] The committee expects that other situations where an interest in an entity is pledged may also be treated as an indirect pledge of the entity's installment receivables. For example, where five taxpayers contribute installment obligations to a corporation in exchange for all of the corporation's stock, and the exchange did not result in recognition of gain on the obligations, the pledge of the stock in such corporation may be treated as a pledge of the corporation's installment obligations.

[8] The committee intends that the Treasury Department will issue regulations that delineate the situations that will be treated as clearly indicating that assets other than installment obligations are considered the source of payment on indebtedness.

by the factory, and the value of the factory significantly exceeds the amount of the borrowing.

Effective Date

The committee bill generally applies to the pledges of installment obligations after December 31, 1985. Installment obligations arising after September 25, 1985, that are pledged before January 1, 1986, are treated as pledged on January 1, 1986, if still outstanding.

Where installment obligations arising from the sale of inventory or property held by a taxpayer for sale to customers in the ordinary course of a trade or business are pledged during calendar year 1986 (including obligations arising after September 25, 1985, that are treated as pledged on January 1, 1986), the indebtedness is taken into account under the provision ratably over a three year period beginning in the taxable year in which the pledge occurred; where such obligations are pledged in calendar year 1987, the indebtedness is taken into account under the provision ratably over a two year period beginning in the year in which the pledge occurred. Thus, where payments are received on the pledged obligations subsequent to the pledge, gain attributable to such payments is to be recognized under the general provisions of the committee bill, and for this purpose, the ratable portion of the indebtedness that is taken into account in taxable years subsequent to the pledge shall be treated as being taken into account on the first day of such subsequent taxable years.

The committee bill does not apply to the pledge of obligations arising from sales of units of a specified residential condominium project on which substantial work had advanced as of September 25, 1985, and in connection with which certain low-income housing was constructed.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $752 million in 1986, $881 million in 1987, $1,594 million in 1988, $1,547 million in 1989, and $900 million in 1990.

4. Accounting for Production Costs and Long-Term Contracts (secs. 904 and 905 of the bill and sections 194 and 451, and new section 263A, of the Code)

Present Law

In general

Producers of tangible property generally may not deduct currently the costs incurred in producing the property. Rather, production costs must be capitalized and recovered through an offset to sales price if the property is produced for sale, or through depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. Although substantially all direct production costs must be capitalized, the treatment of indirect costs may vary depending on the type of property produced. For example, different rules may apply depending on whether the

property is fungible property held in inventory, nonfungible property held for sale to customers, property produced under a long-term contract, farm products, or timber.

Inventories

Taxpayers must maintain inventories[9] and generally must use the accrual method of accounting for purchases and sales for tax purposes whenever necessary to clearly determine their income (sec. 471). In general, all producers and sellers of tangible goods must maintain inventories under methods prescribed by the Internal Revenue Service as conforming to the best accounting practice in the particular trade or business and as clearly reflecting income.

The Treasury regulations require that all direct and indirect "production costs" (that is, those costs incident to, and necessary for, production or manufacturing operations and processes) be included in an inventory account and not used to reduce taxable income until the goods to which they relate are disposed of. The determination of which direct and indirect costs constitute such "production costs" is made in accordance with the "full absorption" method.[10] Direct production costs required to be included in an inventory account include the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the labor that is directly involved in fabrication of the product. Direct labor costs include not only wages and salaries of production workers and supervisors, but also such items as vacation and holiday pay, payroll taxes and payments to supplemental unemployment benefit plans paid or incurred on behalf of employees engaged in direct labor.[11]

Under the full absorption method, indirect production costs are divided into three categories: costs in Category 1 must be included in inventory costs; costs in Category 2 do not have to be included in inventory costs; and costs in Category 3 must be included in inventory costs only if they are included in inventory costs for purposes of the taxpayer's financial reports.

Category 1 costs.—Category 1 costs include:

(1) repair expenses,

(2) maintenance,

(3) utilities, such as heat, power, and light,

(4) rent,

(5) indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,

(6) indirect materials and supplies,

(7) tools and equipment not capitalized, and

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[9] The purpose of maintaining inventories is to assure that the costs of producing or acquiring goods are matched with the revenues realized from their sale. Inventory accounting accomplishes this by accumulating production or acquisition costs in an inventory account as they are incurred rather than allowing an immediate deduction when incurred. When the related goods are sold, these costs are removed from the inventory account and recorded as costs of sale, which reduces taxable income for the year of the sale.

[10] Treas. Regs. sec. 1.471-11.

[11] Treas. Reg. sec. 1.471-11(b)(2).

(8) costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes.[12]

Category 2 costs.—Category 2 costs include:

(1) marketing expenses,

(2) advertising expenses,

(3) selling expenses,

(4) other distribution expenses,

(5) interest,

(6) research and experimental expenses, including engineering and product development expenses,

(7) losses under section 165,

(8) percentage depletion in excess of cost depletion,

(9) depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported for financial statement purposes,

(10) income taxes attributable to income received on the sale of inventory,

(11) pension contributions to the extent they represent past services costs,

(12) general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(13) salaries paid to officers attributable to the performance of services that are incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations.[13]

Category 3 costs.—Category 3 costs include:

(1) taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations,

(2) depreciation reported on financial statements and cost depletion on assets incident to and necessary for production or manufacturing operations or processes,

(3) pensions and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes,

(4) costs attributable to rework labor, scrap, spoilage, and strikes that are incident to and necessary for production or manufacturing operations or processes,

(5) factory administrative expenses (not including any cost of selling or any return of capital),

(6) salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

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[12] Treas. Reg. sec. 1.471-11(c)(2)(i).
[13] Treas. Reg. sec. 1.471-11(c)(2)(ii).

(7) insurance costs incident to and necessary for production or manufacturing operations or processes (e.g., insurance on production machinery and equipment).[14]

If a taxpayer uses a method of accounting for financial reporting purposes that would not be allowable for Federal income tax purposes (such as the "prime cost" method, which includes as inventory costs only direct costs), taxes, depreciation, production-related officers' salaries, and insurance costs must be taken into account in inventory. Employee benefit costs and costs attributable to strikes, rework labor, scrap, and spoilage are treated as Category 2 costs and need not be included in inventory costs.[15]

Indirect production costs required to be treated as inventory costs must be allocated to goods in a taxpayer's ending inventory using a method of allocation that fairly apportions such costs among the goods produced. The regulations authorize use of either the standard cost method or the manufacturing burden rate method. In general, the standard cost method assigns a predetermined rate (e.g., $X per direct labor hour) for each element of product cost, including direct materials and labor and fixed and variable overhead. The manufacturing burden rate method is similar to the standard cost method but assigns predetermined rates only to overhead costs.

Self-constructed property and nonfungible property produced for sale

Under present law, the cost of acquiring, constructing, or improving buildings, machinery, equipment, or other "capital" assets having a useful life substantially beyond the end of the taxable year is not currently deductible (sec. 263).[16] Rather, such capital expenditures become part of the basis of the acquired, constructed, or improved property. These costs may be recoverable over the useful life of the property through depreciation or amortization deductions if the property is used in a business or investment activity and is subject to an allowance for depreciation or amortization. Otherwise, such costs are recoverable when the property is sold or disposed of. At the time of sale or disposition, any unrecovered basis of the asset is offset against the amount realized in computing gain or loss on the sale.

A taxpayer that constructs a building or other capital asset for its own use[17] must capitalize all direct construction costs such as direct materials and labor. Moreover, depreciation on the taxpayer's equipment used to construct the property may not be deducted currently but must be capitalized into the basis of the self-constructed property.[18]

The proper tax treatment of many indirect expenses incurred in connection with the self-construction of property, however, is un-

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[14] Treas. Reg. sec. 1.471-11(c)(2)(iii).

[15] Treas. Reg. sec. 1.471-11(c)(3).

[16] *See* also, Treas. Reg. secs. 1.263(a)-2(a); 1.263-1(b); 1.446-1(a)(4)(ii); 1.461-1(a)(2).

[17] The applicability of the full absorption rules to constructors of nonfungible property (e.g., houses) held for sale rather than for the use of the constructor is unclear, in view of the reference in the regulations which provides that all "manufacturers" must apply the rules. Treas. Reg. sec. 1.471-11.

[18] *Idaho Power Co.* v. *Commissioner*, 418 U.S. 1 (1974).

certain. One line of cases refers to the authority of section 446(b), which requires use of an accounting method that clearly reflects income, and to *Idaho Power* case that vacation pay, payroll taxes, health and welfare benefits, and general overhead costs and executive salaries attributable to self-construction must be capitalized rather than deducted currently.[19] Other cases have used a facts and circumstances test and ruled that such indirect costs need be capitalized only to the extent they are incremental or variable overhead costs (that is, are in excess of fixed overhead or vary significantly with the level of self-construction).[20]

The use of "incremental" costing for indirect costs (in lieu of full absorption costing) is expressly forbidden for inventory under the Treasury regulations, but the Treasury regulations provide no such prohibition for self-constructed property. Indeed, in some instances, the Internal Revenue Service has permitted the deductibility of certain indirect costs incurred during self-construction. In the *Idaho Power Co.* case, the Internal Revenue Service conceded that the taxpayer could deduct payroll taxes incurred with respect to employees engaged in construction of the property.

Long-term contracts

Special accounting rules may apply to taxpayers providing goods under certain contracts spanning two or more taxable years.

A taxpayer with income and expenses from "long-term contracts" may report under the traditional cash or accrual methods which are, subject to the restrictions previously mentioned,[21] generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts may be accounted for on one of two alternative methods—the percentage of completion method or the completed contract method.

A long-term contract for this purpose is a building, installation, construction, or manufacturing contract that is not completed within the taxable year in which it was entered. A manufacturing contract qualifies, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[22]

Percentage of completion method.—Under the percentage of completion method, which is used only for long-term contracts, income is recognized according to the percentage of the contract that is completed during each taxable year. The determination of the portion of the contract completed during the taxable year may be

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[19] See, e.g., *Adolph Coors Co.* v. *Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976) (Internal Revenue Service is justified in requiring capitalization of overhead costs of construction); *Louisville & Nashville R.R. Co.* v. *Commissioner*, 641 F.2d 735, (6th Cir. 1981), aff'g, rev'g, and remanding 66 T.C. 962 (1976) (upheld Tax Court's determination that vacation pay and health and welfare benefits were subject to capitalization, but reversed as to payroll taxes); *Variety Construction Co.* v. *Commissioner*, T.C. Memo 1962-257 (1962) (overhead costs held subject to capitalization).

[20] *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275 (1967) (incremental method and full absorption method equally permissible because taxpayer used the method for 35 years and the Internal Revenue Service had previously audited the taxpayer and did not object). See also I.T. 2196, IV-2 C.B. 112 (1925); *Paducah Water Co.* v. *Commissioner*, 33 F.2d 559 (D.C. Cir. 1929).

[21] For example, the cash method normally may not be used by a taxpayer required to maintain inventories.

[22] Treas. Reg. sec. 1.451-3.

made by either (i) comparing the costs incurred during the year to the total estimated costs to be incurred under the contract, or (ii) comparing the work performed during the year with the estimated total work to be performed.[23] All costs attributable to the long-term contract are deductible in the year in which they are incurred, although a contractor must maintain inventories for materials and supplies.

Completed contract method.—Under the completed contract method, the entire gross contract price of a long-term contract is included in income in the taxable year in which the contract is finally completed and accepted. All costs properly allocable to a long-term contract are deducted in the year of completion.

Regulations adopted in 1976 provide detailed rules for the treatment of contract costs. These costing rules essentially parallel the full absorption rules, except that most Category 3 costs must be inventoried under the completed contract method. Fringe benefit costs and the costs of strikes, rework labor, scrap, and spoilage, however, may be deducted as period costs. Thus, unless a contract is subject to the "extended period long-term contract" rules described below, the following costs are currently deductible: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefit the contractor's activities as a whole (e.g., payroll, legal, and accounting expenses); research and experimental expenses under section 174; losses under section 165; percentage depletion in excess of cost depletion; depreciation and amortization on idle equipment and facilities; the excess of depreciation or amortization reported for tax purposes over that reported on financial statements: income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage; and salaries of officers that benefit the contractor's activities as a whole.

In the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (TEFRA), Congress directed the Treasury Department to modify the rules relating to allocation of costs to long-term contracts. In the case of "extended period" long-term contracts—those that are not expected to be completed within 24 months—certain costs previously treated as period costs were to be allocated to the contracts to the extent they either directly benefit or were incurred by reason of such contracts. These costs included:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) distribution expenses, such as shipping costs;

(3) general and administrative expenses properly allocable to long-term contracts under regulations to be prescribed by the Treasury Department;

(4) research and development expenses that either are directly attributable to particular long-term contracts existing when

[23] Treas. Reg. sec. 1.451-3(c)(2).

the expenses are incurred, or are incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities currently being used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) percentage depletion in excess of cost depletion.

An exception to these rules was provided for contracts for the construction of real property if the contract is expected to be completed within three years, or if the contractor's average annual gross receipts for the three taxable years preceding the year of the contract do not exceed $25 million. The regulations as adopted in 1976 continue to apply to these construction contracts and to all other long-term contracts expected to be completed within two years.

The legislative history of TEFRA expressed Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefits extended period long-term contracts must be allocated to such contracts, even though the same type of costs also benefit other activities of the taxpayer. However, general and administrative expenses that are incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) were intended to be currently deductible.[24]

The Treasury Department issued proposed regulations in 1983 which reflected the TEFRA modifications and clarifications. Under the proposed regulations, the principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involve the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation must be capitalized in the former, whereas all such depreciation must be capitalized in the latter); the deductibility of current pension costs (deductible for the former but not the latter); and general and administrative expenses (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances partially allocable to the contract for the latter).[25]

In addition, rework labor, scrap, and spoilage costs are subject to capitalization in the case of extended period long-term contracts, but not for other long-term contracts.

The proposed regulations, which have not yet been adopted as final, take an expansive view of general and administrative expenses that directly benefit extended period long-term contracts. The types of functions for which no allocation of costs is required are limited, including overall management and policy guidance (e.g., services by the board of directors and the chief executive, fi-

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[24] S. Rept. No. 97-530, 97th Cong., 2d Sess. (1982), at 547.

[25] The proposed regulations do not distinguish between long-term and extended period long-term contracts insofar as research and experimental costs are concerned. Thus, research and experimental costs directly related to either a long-term contract or an extended period long-term contract must be capitalized.

nancial, legal, and accounting officers if no substantial part of their services relate to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[26]

Farming and ranching

The Code and Treasury regulations provide a number of special benefits to taxpayers engaged in the business of farming or raising livestock, including an election to use the cash method of accounting, the right to use special inventory methods if an accrual method is adopted, and the right to deduct certain costs that would otherwise have to be capitalized.

Election to use cash method of accounting.—Although, as producers of goods for sale, farmers and ranchers would be required to maintain inventories and use the accrual method, historically they have been exempted from these requirements. Instead, they may elect a "simplified cash method" based on the premise that establishing and deferring the precise costs of raising crops and animals may be onerous for farmers and ranchers.[27]

Farmers and ranchers who adopt the cash method generally may deduct the costs of producing crops and raising livestock in the year of payment. Expenditures for buildings, machinery, and other capital assets are subject, however, to the normal capitalization requirements of section 263. In addition, the Internal Revenue Service takes the position that amounts paid for supplies such as feed and fertilizer that will not be consumed until a later taxable year may not be deductible currently if current deduction would cause a material distortion of income, or if the prepayment does not have a business purpose.[28]

Special rules apply to passive farmers operating through "farming syndicates." Payments by farming syndicates for feed, seed, fertilizer, or other similar farm supplies may be deducted no earlier than the taxable year in which they are consumed (sec. 464).[29] The cost of poultry purchased for use in a business, or for use in a business and for sale, must be capitalized and deducted over 12 months.

A farming syndicate is defined as a partnership, S corporation, or other noncorporate enterprise engaged in the business of farming, more than 35 percent of the losses of which are allocable to limited partners or other similar types of passive investors. These restrictions also apply to any "tax shelter," defined as an enterprise the principal purpose of which is the avoidance or evasion of Federal income tax (secs. 461(i)(4) and 6661(b)(2)(C)(ii)).

Certain other passive farmers using the cash method are subject to the further restriction, generally applicable to accrual taxpayers, that no deduction may be claimed for an item until "economic per-

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[26] *See* Prop. Treas. Reg. sec. 1.451-3(d)(9)(vi). Thus, a portion of many overhead expenses that benefit both overall management and policy functions must be allocated under a burden rate or other reasonable method.

[27] See *U.S.* v. *Catto*, 384 U.S. 102, 111, n. 15 (1966).

[28] See Rev. Rul. 79-229, 1979-2 C.B. 210.

[29] These rules apply whether the syndicate uses the cash or the accrual method of accounting. Supplies described in sec. 464 may also constitute preproductive period expenses subject to sec. 447 or sec. 278 (see discussion below), in which case they would have to be capitalized.

formance" has occurred (sec. 461(i)).[30] In the case of the purchase of goods or services, economic performance occurs when the goods or services are received.

The cash method is not available to corporations or partnerships with one or more corporate partners that are engaged in farming or ranching. Such taxpayers are required to report on an accrual basis and to capitalize "preproductive period expenses." Preproductive period expenses are expenses incurred prior to the disposition of the first marketable crop or yield in the case of farm property having a useful life in excess of one year or expenses incurred prior to disposition in the case of other property (sec. 447). Exceptions to these rules are provided for certain family-owned corporations and for corporations whose gross receipts for each prior taxable year after 1975 does not exceed $1 million. The rules do not apply to taxpayers engaged in the production of timber.

In addition, special rules may limit the deductibility of some costs incurred in the production of orchard, vineyard, and grove crops. Amounts paid or incurred in planting, cultivating, maintaining, or developing citrus or almond groves before the end of the fourth taxable year after planting must be capitalized (sec. 278(a)). The developmental costs of growing other such crops (including nuts other than almonds) may be deducted currently by taxpayers that are not either corporations subject to section 447 or farming syndicates subject to section 464 or to section 278(b) (described below).[31]

If the taxpayer is a "farming syndicate" (defined in the same manner as for the prepaid feed, fertilizer, etc. expense limitation of sec. 464), planting and maintenance costs incurred with respect to any grove, orchard, or vineyard must be capitalized if incurred prior to the first taxable year in which there is a crop or yield in commercial quantities (sec. 278(b)). The capitalization requirements of section 278 do not apply to deductible amounts attributable to replanting following crop loss or damage due to freezing temperatures, disease, drought, pests, or casualty (sec. 278(c).

Special inventory methods for accrual-method farmers.—Although a farmer electing to use the accrual method must use inventories in computing income, special rules are provided for the computation of gross income. The regulations do not require a computation of cost of goods sold, but provide instead for (1) an inclusion of the farmer's ending inventory in gross income and (2) a deduction of opening inventory and purchases during the year. This achieves essentially the same result as a deduction for cost of goods sold.[32]

Special rules also are provided for valuing inventory. Rather than valuing inventory under the conventional cost or lower of cost or market methods, farmers may value their inventories of livestock or other farm products using the "farm-price" method. In addition, livestock may be valued under a third method, the "unit-

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[30] Taxpayers subject to this restriction include (1) any enterprise (other than a C corporation) whose securities or interests must be registered under Federal or State securities laws prior to sale, (2) a syndicate as defined in sec. 1256(e)(3)(B), and (3) a tax shelter as defined in sec. 6661(b)(2)(C)(ii) (i.e., the principal purpose of which is tax avoidance).

[31] Rev. Rul. 83-28, 1983-1 C.B. 47.

[32] Treas. Reg. sec. 1.61-4(b).

livestock-price" method. (Livestock acquired by the taxpayer for draft, breeding, dairy, or sporting purposes also may be treated as a capital asset subject to depreciation rather than inventory, provided such practice is consistently followed.)[33] Under either the farm-price method or the unit-livestock-price method, all expenditures that would have to be inventoried may be deducted when incurred (subject to any applicable restrictions, such as the capitalization requirements of sec. 447).

Under the farm-price method, inventories are valued at their market value minus any direct costs of disposition.[34] If the farm-price method is elected, it generally must be used for all of the taxpayer's inventories. However, livestock, whether purchased or raised, may be valued under the unit-livestock-price method or may be capitalized and depreciated.[35]

Under the unit-price-livestock method, the taxpayer must group livestock according to kind and age and apply a standard unit price for each animal within each class. The value of each animal is then increased annually by a standard amount reflecting the cost of raising an animal in that class.[36] If the taxpayer elects the unit-price-livestock method, all livestock raised by the taxpayer must be valued under this method; thus, none may be treated as a capital asset subject to depreciation.[37]

Timber

Under present law, the direct costs of acquiring or creating standing timber must be capitalized and recovered through depletion allowances if the timber is harvested or in determining the amount of any gain or loss if the timber is sold. The cost of creating timber includes amounts paid for seed or seedlings, for site preparation, for planting (including the cost of tools, labor, and depreciation on machinery and equipment), and for early stand establishment.[38] Costs incurred for management and protection after stand establishment (generally one or two years after planting) are generally deductible currently. Expenses in this category would include labor and materials for fire, disease, and insect control and for removal of unwanted trees and brush. Costs incurred for reforestation after 1979 may be eligible for seven-year amortization to the extent they do not exceed $10,000 per year (sec. 194).

Under present law, carrying charges such as property taxes, interest, costs of administration, and costs of protecting timber either may be deducted currently or added to the taxpayer's basis in the timber, whether the property is productive or unproductive.[39]

Interest and taxes incurred during construction

Interest and taxes incurred by a taxpayer during construction or improvement of real property (other than low-income housing) to

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[33] Treas. Reg. secs. 1.61-4(b) and 1.162-12(a). Certain livestock may be eligible for the investment tax credit (see sec. 48(a)(6)).
[34] Treas. Reg. sec. 1.471-6(d).
[35] Treas. Reg. sec. 1.471-6(d); Rev. Rul. 77-326, 1977-2 C.B. 184.
[36] Treas. Reg. sec. 1.471-6(e).
[37] Treas. Reg. sec. 1.471-6(f) and (g).
[38] See Treas. Reg. sec. 1.611-3(a); Rev. Rul. 75-467, 1975-2 C.B. 93.
[39] See Treas. Reg. sec. 1.266-1; Rev. Rul. 75-467, 1975-2 C.B. 93.

be used in its trade or business or held in an activity engaged in for profit generally must be capitalized and amortized over 10 years (sec. 189). The construction period commences with the date on which construction of the building or other improvement begins and ends on the date it is ready to be placed in service or held for sale.[40]

The legislative history of amendments to this provision indicates Congress' intention that the Treasury Department issue regulations allocating interest to expenditures for real property during construction consistent with the method prescribed by Financial Accounting Standards Board Statement Number 34 (FAS 34). Under FAS 34, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction, and interest costs incurred by reason of borrowings that could have been repaid with funds expended for construction.[41]

No regulations relating to this provision have been proposed or adopted to date.

Reasons for Change

Preproduction costs

The committee believes that the present-law rules regarding the capitalization of costs incurred in producing tangible property are deficient in two respects. First, the existing rules may allow costs that are, in fact, costs of producing property to be deducted currently, rather than to be capitalized into the basis of the property and recovered when the property is sold (or as it is used) by the taxpayer. This produces a mismatching of expenses and the related income, which may result in offsetting the expenses against unrelated income of the taxpayer and inappropriately deferring taxes. Second, different capitalization rules may apply under present law depending on the nature of the property and its intended use. These different results may distort the allocation of economic resources and the manner in which certain economic activity is organized.

The committee believes that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of production costs for all tangible property, subject to appropriate exceptions where application of the rules might be unduly burdensome.

Long-term contracts

The committee also believes that the current rules permitting the completed contract method of accounting for long-term contracts permit the deferral of the taxation of the income from those contracts, because the entire gross contract price of a long-term contract is included in income only in the taxable year in which

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[40] H. Rep. No. 97-760, 97th Cong., 2d Sess. (1982) at 485.
[41] Id.

the contract is finally completed and accepted. The Study of 1983 Effective Tax Rates on Selected Large U.S. Corporations by the Joint Committee on Taxation indicates that corporations had large deferred taxes attributable to this accounting method and low effective tax rates. Annual reports for the large defense contracts indicate extremely low (or negative) tax rates for several years due to large net operating loss deductions arising from the use of the completed contract method and the use of this method generally.

Accordingly, the committee believes that income from long-term contracts should be reported on the percentage of completion method, which annually recognizes income and expenses in proportion to the percentage of the contract that has been completed that year. Nonetheless, the committee realizes that use of the percentage of completion method may produce harsh results in some cases, for example, where an overall loss is experienced on the contract, or where actual profits are significantly less than projected. The committee believes that, in order avoid these possible results, it is appropriate to provide that, at the end of a contract, interest be paid to the taxpayer (or to the Federal government) where taxes paid under the percentage of completion method for any year are more (or less) than the taxes that would have been paid if the actual income from a long-term contract were spread over the life of the contract on the basis of actual costs.

Explanation of Provisions

a. In general

The committee bill provides a uniform set of capitalization rules for inventory and construction costs. In addition, interest costs generally will be subject to capitalization in the case where the interest is allocable to property that is long-lived or requires an extended period to produce, as described below. The uniform capitalization rules do not apply to property produced under a long-term contract, or to farm products and timber produced by certain persons, which are subject to special rules described below.

b. Uniform capitalization rules

The committee bill generally applies the capitalization requirements applicable to extended period long-term contracts to all activities involving the production or manufacture of real or personal property, including (a) goods to be held in inventory or for sale to customers in the ordinary course of business and (b) assets (or improvements to assets) constructed by a taxpayer for use in its own trade or business or in an activity engaged in for profit. Accordingly, producers of such property are required to capitalize not only the direct costs of production, but also an allocable portion of most indirect costs that benefit production, including general and administrative and overhead costs. The committee bill provides that allocations of indirect production costs among items produced, or between inventory and current expense, are to be made under rules similar to those provided under present law.[42] The capitalization

[42] See Treas. Reg. sec. 1.471-11(d) and Prop. Treas. Reg. sec. 1.451-3(d)(9).

rules of the committee bill do not apply, however, to any portion of costs constituting research and experimental expenditures under section 174. In addition, the capitalization rules do not apply to expenditures not relating to the manufacture, remanufacture, or production of property that are treated as repairs under present law. The provisions of the committee bill do not modify the present law rules relating to valuation of inventories on a basis other than cost.

Under these new absorption rules, contributions to a qualified pension, profit-sharing, or stock bonus plan are allocated between inventory costs and other costs. This allocation between inventory costs and other costs is independent of any allocation between "normal cost" and "past-service cost" required under the minimum funding standards (sec. 412). Those costs allocable to inventory are to be included in inventory costs for that year. Those costs not allocable to inventory costs are to be treated under the usual tax rules applicable to those costs.

For example, in the case of a qualified defined benefit pension plan that is subject to the minimum funding standard, the new absorption rules require that an employer (1) calculate liability under the minimum funding standards (using the applicable funding method and actuarial assumptions), (2) calculate the limit on deductions for such contributions (pursuant to section 404 of the Code), and (3) allocate the otherwise deductible amount between inventory costs and other costs. Such allocation is independent of that required by the minimum funding standard rules or the plan's benefit formula and is to be based on accounting principles pursuant to regulations issued by the Secretary of the Treasury.

Similarly, in the case of a plan that is not subject to the minimum funding standard (e.g., a profit-sharing plan), this provision requires that the employer compute the otherwise allowable deduction limit pursuant to section 404 and then allocate that amount between inventory costs and other costs on the basis of accounting principles, pursuant to Treasury regulations.

c. Interest

Interest on debt incurred or continued to finance the construction or production of real property or other property in Classes 7, 8, 9, or 10 of the committee bill's depreciation system for tangible property[43] must be capitalized, if the property is used by the taxpayer in its trade or business or an activity for profit. The interest capitalization rules do apply to property produced by the taxpayer for personal purposes. Interest incurred in connection with other property with a production period of more than two years (one year in the case of items costing more than $1 million) also is subject to capitalization. The production period for property would begin when construction or production is commenced and end when the property is ready to be placed in service or is ready to be held for sale. Activities such as planning or design generally would not cause the production period to begin.

The committee intends that the determination of whether interest is incurred or continued to finance the production of property

[43] In general, this encompasses buildings and other real property that is 15-year or 18-year property under present law, plus certain other long-lived assets.

will be made under rules similar to those applicable under section 189 of present law. Under these rules, any interest expense that would have been avoided if production or construction expenditures had been used to repay indebtedness of the taxpayer is treated as construction period interest subject to capitalization. Accordingly, under the committee bill, debt that can be specifically traced to production or construction expenditures first will be allocated to production or construction. If production or construction expenditures exceed the amount of this debt, interest on other debt of the taxpayer will be treated, to the extent of this excess, as production or construction period interest.[44] For this purpose, the assumed interest rate would be an average of the rates on the taxpayer's outstanding debt (excluding debt specifically traceable to production or construction). The committee contemplates that the Treasury Department will issue regulations to prevent the avoidance of these rules through the use of related parties.

If production or construction is for a particular customer who makes progress payments or advance payments for property to be used in a business or activity for profit, or held for sale, the customer is treated as constructing the property to the extent of such payments. Thus, interest costs attributable to payments to the contractor are subject to capitalization by the customer if the property is long-lived property or requires a production or construction period of more than two years (one year if the cost exceeds $1 million). The contractor must capitalize interest only with respect to the excess of its accumulated contract costs over the accumulated payments received by the contractor during the year.

d. Special rules for farmers and ranchers

Capitalization rules generally

Under the committee bill, the uniform capitalization rules, including those requiring capitalization of interest, generally apply to all crops and livestock (other than animals held for slaughter) having a preproductive period of more than two years. For this purpose, the preproductive period of plants is deemed to begin when the plant or seed is first planted or acquired by the taxpayer, and to end when the plant becomes productive or is sold. The preproductive period of animals begins at the time of acquisition, breeding, or embryo implantation, and ends when the animal is ready to perform its intended function. Thus, for example, in the case of a cow used for breeding, the preproductive period ends when the first calf is dropped.

The committee intends that the preproductive period of a plant grown in the United States be determined on the basis of the national average preproductive period for the particular crop. It is expected that the Treasury Department will publish periodically a list of the preproductive periods of various plants based on a weighted average for products produced in the United States in commercial quantities.[45]

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[44] Production or construction expenditures would include the cumulative production costs (including previously capitalized interest) required to be capitalized.

[45] The Treasury Department may make reasonable distinctions among different varieties of plants, and may weight the average using such factors as it deems appropriate.

The committee intends that taxpayers may determine the costs required to be capitalized by using methods similar to one of the simplified inventory valuation rules of present law (e.g., the farm-price or unit-livestock-price method), in lieu of capitalizing actual costs.

Persons or entities required to use the accrual method of accounting under section 447 are required to capitalize proproductive costs without regard to whether the preproductive period is more than two years. Consistent with the general capitalization rules, such taxpayers are required to capitalize taxes and, to the extent the preproductive period exceeds two years, interest incurred prior to production. The committee intends that taxpayers properly using the annual accrual method of accounting under section 447(g) will be allowed to continue to use that method.

Under the committee bill, the special rule of present law permitting expensing of amounts incurred in replanting after loss or damage due to freezing temperatures, disease, drought, pests, or casualty (sec. 278(c)) is expanded with respect to edible crops to include expenditures in connection with planting or maintaining a field other than the field in which the damage occurred. The expenditures qualifying for expensing under this provision are limited to those incurred with respect to the same acreage as the field to which the damage occurred.

Election to deduct preproductive period expenses

The committee bill provides an exception to the rules requiring capitalization of productive period expenses for certain farmers. Under this exception, a farmer may elect to deduct currently all preproductive costs of plants and animals that may be deducted under present law. If the election is made, gain from disposition of the product is recaptured (that is, taxed as ordinary income) to the extent of prior deductions that otherwise would have been required to be capitalized. In addition, the electing farmer is required to use the nonincentive depreciation system for all farm assets placed in service in taxable years for which the election is in effect.

For this purpose, the term "farmer" includes producers of livestock, nursery stock, and Christmas and other ornamental trees, as well as agricultural crops. It does not include tax shelters (as defined in section 6161(b)(2)(C)(ii)), taxpayers required to use the accrual method of accounting (under section 447), farming syndicates (as defined in section 464(c)), and producers of pistachio nuts.

The election to deduct preproductive costs currently does not apply with respect to any item of cost which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting. Producers of timber are subject to special rules described below.

The election to expense preproductive period costs is irrevocable, except with the consent of the Commissioner, and is binding on the spouse and all minor children of the taxpayer, and on any entity in

which the taxpayer owns a 50 percent or more interest (applying the attribution rules of section 318(a)). In the case of a partnership or S corporation, the election must be made at the partner or shareholder level. The election may be made only for the first taxable year that begins after December 31, 1985, and during which the taxpayer is a farmer.

The committee intends that taxpayers making the election be allowed to estimate the amount of preproductive period expenses subject to recapture using methods similar to one of the simplified inventory methods permitted to accrual method farmers under present law.

e. Long-term contracts

The committee bill repeals the completed contract method of accounting for "long-term contracts" and redefines the term "long-term contract" to include any contract for the production, manufacture, building, installation, or construction of tangible property if such contract is not completed before the date one year after the date on which the contact was commenced. The committee bill provides, however, that the completed contract method of accounting (including the present law rules relating to which costs are subject to capitalization) may continue to be used in the case of a contract for the construction of real property that is expected to be completed within the two-year period beginning on the commencement date of the contract, if performed by a taxpayer whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed $10 million.[46]

Aggregation and severance rules similar to those provided under present law, under which separate contracts that are interdependent may be treated as a single contract and a single contract may be treated as several independent contracts, apply. For example, if a contract is for 500 folding chairs at $10 per chair (which is the price normally charged for this type of chair) to be delivered 100 chairs each year for five years, this contract is treated as five separate contracts and not a long-term contract. On the other hand, if five separate contracts are for five airplanes of the same type and the price of the first plane is $10 million and the price of each succeeding airplane is $2 million, these contracts are aggregated and treated as one contract. The contract price of this aggregated contract must be reported on the percentage of completion method of the committee bill.

Income from all long-term contracts must be reported under the percentage of completion method based on the expected costs rather than physical completion. Thus, the amount of gross income from a long-term contract recognized in a particular taxable year generally is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by amounts of gross contract price that were included in gross income in previous taxable years.

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[46] Under present law, the completed contract method of accounting is available for certain contracts that span more than one taxable year, irrespective of when the contract is commenced or completed.

In the taxable year in which the contract is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if the actual costs and contract price, rather than anticipated contract price and costs, had been used to compute gross income. Interest must be paid by the taxpayer if there is an underpayment with respect to a taxable year under this "lookback" method, and is paid to the taxpayer if there is an overpayment. The rate of interest for both overpayments and underpayments is the 91-day Treasury bill rate plus two percentage points, compounded daily.

f. Timber

The committee bill requires that the costs of producing timber, including interest costs, be capitalized using the uniform capitalization rules. Generally, costs which are required to be capitalized by the committee bill are to be added to the basis of the timber and recovered either through depletion deductions as the timber is cut or in determining the amount of gain if the timber is sold, as is the case under present law.

The committee bill provides special transitional relief for those production costs that are not required to be capitalized by present law, but are required to be capitalized by the committee bill, and which are attributable to timber planted before 1986. For the first taxable year for which the committee bill is effective, only 20 percent of such costs are required to be capitalized. The remainder of such costs (80 percent in the first year for which the committee bill is effective) may be expensed in the same manner as present law. The percentage of such costs required to be capitalized increases by an additional 20 percent each year. Thus, 40 percent of such costs are required to be capitalized in the second year for which the committee bill is effective, 60 percent in the third year, 80 percent in the fourth year, and all of such costs in the fifth year for which the committee bill is effective.

The committee bill provides an election for "qualified small timber producers" to amortize, over a period of five years, amounts required to be capitalized by the committee bill which are currently eligible to be expensed, rather than adding such costs to the basis of the timber. A "qualified small timber producer" is a noncorporate producer with timberland of 75,000 acres or less. Timberland is land owned by, or leased to, the taxpayer for use in the timber business. The amount of timberland a taxpayer has for any taxable year is equal to the greatest amount owned by or leased to the taxpayer at any time during the taxable year.

In determining the amount of timberland of any taxpayer, the timberland of all related persons is aggregated and treated as if owned by a single taxpayer. For this purpose, related persons are the taxpayer and the members of the taxpayer's family, a corporation and a taxpayer if 50 percent or more of the value of the stock of the corporation is owned (either directly or by application of section 318) by the taxpayer or a member of the taxpayer's family, a corporation and any other corporation which is a member of the same controlled group described in section 1563(a)(1), and a taxpayer and any partnership if 50 percent or more (in value) of the inter-

ests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

Where a producer has timberland in excess of 50,000 acres, the benefits of the election are phased out at a rate of four percent for each additional 1,000 acres (or part thereof) of timberland. For example, a producer with 60,000 acres of timberland would be able to amortize over five years only 60 percent of the costs eligible for expensing under present law which costs are required to be capitalized by the committee bill. The remaining 40 percent of such costs are required to be treated in the same manner as the costs of a producer other than a qualified small timber producer.

A qualified small timber producer who elects to amortize costs for any year, rather than add them to the basis of the timber, must also elect to use the nonincentive method of depreciation for all depreciable assets which are predominantly used in the timber business that are placed in service during any taxable year for which the election is in effect.

In the case of a partnership, the timberland acreage test is to be applied at both the partner and partnership level. A similar rule applies to subchapter S corporations and their shareholders.

g. Effective dates

In general

The uniform capitalization rules generally are effective for costs and interest paid or incurred after December 31, 1985. Self-constructed assets with respect to which substantial construction was begun before 1986 are exempt from the new rules.

Long-term contracts

The rules requiring use of the percentage of completion method are effective for long-term contracts entered into on or after September 25, 1985.

Timber

Under the general effective date, the capitalization rules apply to costs and interest paid or incurred after December 31, 1985. Under a special transitional rule, production costs, including interest, incurred in the production of timber planted before 1986 and not subject to capitalization under present law are subject to a five-year phase-in. Under this rule, only 20 percent of such costs are to be capitalized in 1986, 40 percent in 1987, and so on.

Inventories

The new rules apply to inventories for the taxpayer's first taxable year beginning on or after January 1, 1986. Taxpayers are required to spread the adjustment resulting from the change in inventory accounting (under section 481) over a period of no more than five years, in accordance with the rules applicable to a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service. *See* Rev. Proc. 84-74, 1984-2 C.B. 736. Under these rules, the adjustment generally is includible in income over a period equal to the lesser of the period the taxpayer has used the method of accounting or a period of five years.

The committee bill contemplates that the changes in the rules governing the absorption of costs into inventory will be treated as a change in the taxpayer's method of accounting. All inventory sold, or otherwise disposed of, after the effective date is expected to reflect the changes in the absorption rules. This requires that inventory on hand as of the effective date be revalued to reflect the greater absorption of production costs under the rules of the committee bill. Normally, the revaluation is expected to be done by valuing the items included in inventory on the effective date as if the new absorption rules had been in effect during all prior periods. Thus, a determination of what direct and indirect production costs should be assigned to each item of inventory is to be made in accordance with the changes contained in the committee bill. The difference between the inventory as originally valued and the inventory as revalued will be the amount of adjustment required by section 481.

In some circumstances, particularly where the taxpayer is considered as holding in inventory items which were produced or manufactured a number of years prior to the effective date of the committee bill, the information necessary to make such a determination may not be available. Such a situation may arise, for example, if the taxpayer has items of inventory which it no longer produces, or if the taxpayer is using the last-in, first-out (LIFO) method of accounting.

The committee expects that the Treasury Department will issue regulations or rulings permitting a taxpayer, who cannot compute the revaluation of a part of its inventory because the information necessary to calculate the revaluation is not available, to be allowed to estimate the amount by which the inventory will be revalued by using available data. For example, assume that a taxpayer that uses the first-in, first-out (FIFO) method of valuing inventories maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1984, for which year the taxpayer determines a revaluation of inventory costs resulting in a 20 percent increase. A portion of the inventory of bolt A, however, is attributable to 1983 for which the taxpayer does not have sufficient data for revaluation. Bolt B was last produced in 1982 and no data exists which would allow revaluation of the inventory cost of bolt B pursuant to the new absorption rules. The inventories of all other bolts are attributable to 1984 and 1985 production, for which revaluation using available data results in an average 15 percent increase in inventory cost. With respect to bolt A, the 20 percent increase determined for 1984 also may be applied to the 1983 production as an acceptable estimate. With respect to bolt B, the overall 15 percent increase for the inventory as a whole may be used in valuing the costs of bolt B.

Taxpayers using the last-in, first-out (LIFO) method of valuing inventories also may have difficulty in assembling sufficient data to restate their inventory costs. Taxpayers using the dollar-value LIFO method may have particular problems since the valuation of each year's LIFO layer is dependent upon prior year's cost data in situations where the double extension method is used.

The committee expects that taxpayers using the specific goods LIFO method to value their inventories generally will be allowed to

use the same type of estimating techniques as FIFO taxpayers. Thus, the percentage change obtained in revaluing those inventory layers for which sufficient data is available may be applied to revalue all preceding year's layers.

For example, assume a manufacturer produces two different parts. Work-in-process inventory is recorded in terms of equivalent units of finished goods. The manufacturer's specific goods LIFO inventory records show the following at the end of 1985:

Product and layer	Number	Cost	LIFO carrying values
Product #1:			
1982	150	$5.00	$750
1983	100	6.00	600
1984	100	6.50	650
1985	50	7.00	350
			2,350
Product #2:			
1982	200	4.00	800
1983	200	4.50	900
1984	100	5.00	500
1985	100	6.00	600
			2,800
Total of carrying value of Products #1 and #2			$5,150

Data available to the taxpayer allows it to revalue the unit costs of product #1 under the new absorption rules to $7.00 in 1983, $7.75 in 1984 and $9.00 in 1985, and to revalue the unit costs of product #2 to $6.00 in 1984 and $7.00 in 1985. The available data for product #1 results in a weighted average percentage change for product #1 of 20.31 percent[47] The available data for product #2 results in a weighted average percentage change for product #2 of 18.18 percent.[48] The revalued costs for product #1 for 1982 can be estimated by applying the weighted average increase determined for product #1 (20.31 percent) to the unit costs originally carried on the taxpayer's records. The estimated revalued unit cost in the case of product #1 would be $6.02 ($5.00 x 1.2031). The costs of product #2 are redetermined in a similar manner for 1982 and 1983 by applying the weighted average increase determined for product #2 of 18.18 percent to the unit costs of $4.00 and $4.50, yielding revalued unit costs of $4.73 and $5.32 respectively.

The weighted average increase estimation does not affect the revaluation of costs for those years in which actual revaluation is

[47] This is computed as follows: [(100 X (7.00 -6.00)) + (100 X (7.75 -6.50)) + [50 X (9.00 -7.00))] divided by [(100 X 6.00) + (100 X 6.50) + (50 X 7.00)].

[48] This is computed as follows: [(100 X (6.00 -5.00)) + (100 X (7.00 -6.00))] divided by [(100 X 5.00) + (100 X 6.00)].

possible. The revalued inventory of the taxpayer would be as follows:

Product and layer	Number	Revalued cost	LIFO carrying values
Product #1:			
1982	150	$6.02	$903
1983	100	7.00	700
1984	100	7.75	775
1985	50	9.00	450
			2,828
Product #2:			
1982	200	4.73	946
1983	200	5.32	1,064
1984	100	6.00	600
1985	100	7.00	700
			3,310
Total carrying value of products #1 and #2 under new absorption rules			6,138.

The amount of the adjustment (under section 481) is $988 ($6,138 - $5,150).

A taxpayer using the specific goods LIFO method also may have inventories for which new costs have not been incurred for several years and, consequently, a weighted average increase for those particular inventory items may not be available for estimation purposes. In such a case, the taxpayer may take the weighted average increases for all its revalued inventory items and determine an overall percentage increase, weighted by the value of each inventory item included in the calculation, to estimate the revaluation necessary for such items.

The committee intends that the Treasury Department develop rules to permit taxpayers using the dollar-value LIFO method who lack sufficient data to revalue all of their LIFO layers under the new absorption rules to compute the percentage change in the current costs of their inventory as a result of the new absorption rules for the LIFO layers accumulated during the three most recent years that the taxpayer has sufficient information. Taxpayers then would apply that percentage to restate the costs of the beginning LIFO inventory value of the entire pool for the year of change. For purposes of determining future indexes, the year prior to the year of change will then be considered as a new base year and the current costs for that year are to be used for extension purposes to future taxable years. The increase in the beginning balance in the LIFO inventory as a result of this change will represent the section 481 adjustment amount.

For example, a calendar year taxpayer first adopted the dollar value LIFO method in 1980, using a single pool and the double extension method. The taxpayer's beginning LIFO inventory for the year of change is as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$14,000	1.00	$14,000
1980 layer	4,000	1.20	4,800
1981 layer	5,000	1.30	6,500
1982 layer	2,000	1.35	2,700
1983 layer	0	1.40	0
1984 layer	4,000	1.50	6,000
1985 layer	5,000	1.60	8,900
	34,000		42,000

The taxpayer is able to recompute inventoriable costs under the new absorption rules for the ending LIFO layers for the three preceding taxable years as follows:

Year	Current cost as recoreded	Current cost as adjusted	Weighted percentage change
1983	$35,000	$45,150	0.29
1984	43,500	54,375	.25
1985	54,400	70,720	.30
Total	132,900	170,245	.28

Applying the average revaluation factor of .28 to each layer, the inventory is restated as follows:

	Base year cost	Index	LIFO carrying value
Base layer	$17,920	1.00	$17,920
1980 layer	5,120	1.20	6,144
1981 layer	6,400	1.30	8,320
1982 layer	2,560	1.35	3,456
1983 layer	0	1.40	0
1984 layer	5,120	1.50	7,680
1985 layer	6,400	1.60	10,240
Total	43,520		53,760

The section 481 adjustment is the difference between the revalued LIFO carrying value under the new absorption rules and the

LIFO carrying value as originally reported. In this example, the section 481 adjustment is $11,760 ($53,760 -$42,000). The section 481 adjustment also may be found by multiplying the LIFO carrying value as originally reported by the average percentage change determined in first step described above. In this example, that procedure also would determine the amount of the section 481 to be $11,760 ($42,000 X .28).

The year prior to the year of change will be treated as a new base year for the purpose of determining the index in future years. This requires that layers in years prior to the base year be restated in terms of the new base year index. In the example above, the restated inventory would be as follows:

	Restated base year cost	Index	LIFO carrying value
Old base layer	$28,672	0.625	$17,920
1980 layer	8,192	.75	6,144
1981 layer	10,272	.81	8,320
1982 layer	4,114	.84	3,456
1983 layer	0	.875	0
1984 layer	8,170	.94	7,680
New base layer (1985)	10,240	1.00	10,240
Total	$69,660		$53,760

For taxpayers not possessing sufficient data to revalue all of their LIFO layers under the new absorption rules, the most recent three years prior to the year of change for which the taxpayer has sufficient information may be used in determining the average revaluation factor. Where the taxpayer possesses sufficient information to use additional years in determining the average revaluation factor, such additional years may be used at the option of the taxpayer, as long as the additional years are consecutive years prior to the year of change. For example, assume a calendar year taxpayer has sufficient information to revalue years 1980 through 1985. The average revaluation factor may be determined on the basis of all six years. On the other hand, a taxpayer with sufficient information to revalue 1979 through 1981 and 1983 through 1985 would use only the 1983 through 1985 years in determining the average revaluation factor, since the years 1979 through 1981 are not consecutive to the year of change.

The use of the average revaluation factor based upon current costs to estimate the revaluation of older inventory layers may result in an increase in the value of inventories representing costs which did not exist in the affected year. To the extent that a taxpayer can show that costs which contributed to the determination of the average revaluation factor could not have affected a prior year, the average revaluation factor as applied to that year may be adjusted by an appropriate amount.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $3,919 million in 1986, $9,542 million in 1987, $13,247 million in 1988, $12,566 million in 1989, and $11,116 million in 1990.

5. Reserve for Bad Debts

(Sec. 906 of the bill and sec. 116 of the Code)

Present Law

In general

Present law allows taxpayers a deduction from income for those debts arising from a trade or business which become wholly or partially worthless during the taxable year (sec. 166(a)). The amount of the deduction may be determined using either the specific charge-off method or the reserve method. The deduction is not available to a cash-method taxpayer who has not taken into income the amount of the debt.

Dealers in property are allowed to establish a reserve for losses which may result from their liability as a guarantor, endorser, or indemnitor on debt which arose as a result of the dealer's sale of real or tangible personal property (sec. 166(f)).

Specific charge-off method

The specific charge-off method allows a deduction for bad debts as the individual debt becomes either wholly or partially worthless. At such time as a receivable is determined to be uncollectible in whole or in part, the receivable is reduced by the amount of uncollectibility, and a deduction is allowed for an equal amount. If an amount previously charged-off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection.

Wholly worthless amounts are allowed as a bad debt deduction for tax purposes in the year in which they become worthless. Partially worthless amounts not only must have become partially worthless for tax purposes, but also must be charged-off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for tax purposes.

Reserve method

Under the reserve method, a deduction is allowed for a reasonable addition to a reserve for bad debts. A reserve account is set up as an allowance against the eventuality that some receivables may later prove to be uncollectible. The reasonable addition to the reserve for any year is that amount which is necessary to bring the beginning bad debt reserve, adjusted for actual bad debt losses and recoveries during the year, to be increased to the allowed ending balance computed under an approved method.[49]

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[49] The actual formula is beginning reserve minus actual worthless debts experienced during the year plus actual recoveries during the year minus deductible addition to reserve equals ending reserve. The formula is solved for the deductible addition after all the other amounts are

Continued

The annual addition to the reserve account is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year of the proposed addition. The most widely used formula for determining the appropriate bad debt reserve for tax purposes is based on the decision in *Black Motor Company v. Commissioner*, 41 B.T.A. 300 (1940), affd 125 F. 2d 977 (6th Cir. 1941). This formula uses a six year moving average, determined by dividing the sum of bad debts actually charged off (net of actual recoveries) for the most recent six years (including the current year) by the sum of the debts owed the taxpayer over the same six year period. This average is multiplied by the amount of debts outstanding at the close of the current year to produce the reserve balance at the close of the current year. The result is a figure based on past experience which approximates the bad debt charge-offs expected to occur in a single taxable year.

The *Black Motor* formula is not the exclusive method for determining the deductible addition to reserve. In addition, the result obtained under the formula must still be determined to be reasonable under the circumstances of the year of computation.

Determination of worthlessness

Both the specific charge-off method and the reserve method require a determination of the period in which a debt becomes totally or partially worthless.

Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor. A debt is not worthless merely because its collection is in doubt. As long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless.

Wholly worthless bad debts may be charged off for tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed. The period in which the debt is actually charged off the taxpayer's books is not determinative. Partially worthless bad debts also must be charged off on the taxpayer's books in order to be charged off for tax purposes. However, a tax charge-off for a partially worthless bad debt may not be taken after the year in which the debt becomes wholly worthless.

Bad debt reserves for guarantees, etc.

Present law requires that an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debt losses. For this reason, no deduction is generally allowed for potential losses of taxpayers who guarantee, endorse, or provide indemnity agreements with respect to debts owed to other.

An exception to this general rule is made for dealers in property. To the extent that these types of potential obligations arise from the sale of real or tangible personal property, dealers may establish a reserve account and deduct additions necessary to maintain it in

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determined. Thus, amounts specifically charged off or recovered are not items of expense or income, but are integral components of the computation of the deductible addition to the reserve.

the same manner as a reserve account for business debts owed directly to the taxpayer. This type of reserve normally arises where a guarantee or other indemnification agreement is given to induce a lender to arrange financing for a dealer's property or where a dealer's receivables are factored with rights of recourse.

Reasons for Change

The committee generally believes that the reserve method of accounting for bad debts should be repealed. Use of the reserve method for determining losses from bad debts results in deductions being allowed for tax purposes for losses that statistically occur in the future. In this regard, the reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Moreover, use of the reserve method allows a deduction prior to the time that the losses actually occur. If a deduction is allowed prior to the taxable year in which the loss occurs, the value of the deduction to the taxpayer will be overstated and the overall tax liability of the taxpayer understated.

Explanation of Provision

In general

The committee bill repeals the availability of the reserve method of computing expenses arising from bad debts for all taxpayers, other than certain financial institutions. The effect of the committee bill is to require bad debt expense to be recognized using the specific charge-off method.

Booking requirement

The committee bill conforms the treatment of wholly worthless debts to the treatment of partially worthless debts by providing that no debt will be deductible as wholly or partially worthless for tax purposes until it is charged off on the taxpayer's books. Thus, no deduction for a worthless debt is allowed prior to the time it is so recognized for other purposes.

This change resolves a potential difficulty which can arise under present law where a taxpayer does not discover that the debt is worthless until a later year. The rules of present law require that the taxpayer amend a prior year's return in order to obtain the deduction. The year of actual worthlessness may be a closed taxable year. The committee bill avoids this problem by requiring the debt to be both worthless and charged-off before a deduction is allowed. Thus, the taxpayer cannot be required to deduct the bad debt in a year prior to the year in which he discovers it to be worthless.

In adopting this change, the committee does not intend to create an opportunity for taxpayers to assign deductions for worthless debts to whichever taxable year will yield the lowest overall tax burden. Thus, where it is clearly demonstrable that a taxpayer is actually aware that a debt is wholly worthless, the committee intends that the deduction be allowable in the year that the taxpayer becomes aware of the bad debt, even if the taxpayer delays charging it off his books in order to avoid tax liability.

Transitional rules

The committee bill treats any change from the reserve method to the specific charge-off method as a result of the committee bill as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. To prevent taxpayers from deducting losses on debts twice, first as a deduction to a reserve for bad debts under current law and later as a deduction due to the debt being specifically charged off after the required change in accounting method, the committee bill requires that the balance in any reserve for bad debts as of the effective date be taken into income ratably over a five-year period.

Effective Date

The provisions are applicable to tax years beginning on or after January 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $976 million in 1986, $1,569 million in 1987, $1,532 million in 1988, $1,577 million in 1989, and $1,592 million in 1990.

6. Accrued Vacation Pay (sec. 907 of the bill and sec. 463 of the Code)

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy (the "all-events" test). In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not treated as having occurred any earlier than the time economic performance occurs. With respect to a liability that arises as a result of another person's providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employee), economic performance generally occurs when such other person provides the services.

Under present law, an exception applies under which certain expenses may be treated as incurred in the taxable year in which the "all-events" test is otherwise met even though economic performance has not yet occurred. This exception applies if four conditions are met: (1) the "all-events" test (determined without regard to economic performance) is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8-1/2 months) as of the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently from year to year treats items of that type as incurred in the taxable year in which the all-events test is met; and (4) either (a) the item is not material, or (b) the accrual of the item in the year in which the all-events test is met results in a better matching of the item with the income to which it relates than would result from accruing the item in the year in which eco-

nomic performance occurs. This exception does not apply to workers' compensation or tort liabilities.

In order to ensure the proper matching of income and deductions in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income.[50] Consequently, an employer is not entitled to a deduction for vacation pay in the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer), or (2) is paid.

An exception to this rule applies to amounts that are paid within 2-1/2 months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e.,when the services of the employee for which vacation pay is earned are performed).

Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees in the current year and expected to be paid by the close of that year or within 12 months thereafter. For example, in the case of a taxpayer who makes this determination at the end of a taxable year, the reasonable addition for the year is the amount necessary so that the balance in the account at the beginning of the next taxable year is the amount reasonably expected to be paid in that year. If the balance in the account, before any addition, is greater than this amount, no additional deduction is allowed. Certain rules also allow a deduction for reductions in certain suspense accounts.

Reasons for Change

The committee believes that the special provision (sec. 463) of present law, under which an employer is entitled to deduct reasonable additions to an account for earned vacation pay expected to be paid within 12 months following the close of the taxable year, is inconsistent with the general principle that no deduction should be provided for a deferred benefit until the employee includes the benefit in income. Moreover, the committee believes that the present-law treatment is inequitable because the rules for accrued vacation pay are more favorable than the rules that apply to other types of compensation or other types of deductible items. The committee believes that the deduction for vacation pay should be subject to no more generous treatment than other items. Consequently, the committee bill limits the deduction for additions to the reserve for vacation pay to amounts paid within 8½ months following the close

[50] Special deduction-timing rules apply to benefits provided under a qualified pension, profit-sharing, or stock bonus plan.

of the taxable year. The committee believes that, by permitting an employer to deduct amounts paid within 8½ months after the close of the taxable year, sufficient flexibility is provided to employers to take account of year-end accruals and normal payroll practices.

Explanation of Provision

Under the committee bill, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8½ months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees.

Effective Date

The provision applies to taxable years beginning after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $81 million in 1986, $74 million in 1987, $20 million in 1988, $17 million in 1989, and $20 million in 1990.

7. Contributions in Aid of Construction (Sec. 908 of the bill and secs. 118(b) and 362(c)(3) of the Code)

Present Law

Under present law, gross income does not include any contribution to capital of a corporation (sec. 118(a)). A corporate regulated public utility that provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services may treat contributions received in aid of construction as non-taxable contributions to capital (sec. 118(b)).

In order to be eligible to be treated as a contribution to capital, the money or property transferred to the utility must be a contribution in aid of construction, any moneys received must be spent for the intended purpose of the contribution within a specified period of time, and the contribution received in aid of construction (or any property constructed or acquired with such contributions) may not be included in the utility's rate base for rate making purposes.

In addition to the exclusion from gross income, present law provides that no deductions are allowable with respect to a contribution in aid of construction and that property purchased with contributions in aid of construction have no depreciable tax basis and are not eligible for the investment tax credit (secs. 118(b) and 362(c)(3)).

Reasons for Change

The committee believes that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility. The committee believes that present law allows amounts that represent prepayments for serv-

ices to be received by corporate regulated public utilities without the inclusion of such payments in gross income. Accordingly, the committee bill repeals the present law treatment and requires the recipient utility to include the value of such contributions in income at the time of their receipt and to depreciate the value of any asset contributed, or purchased with a contribution of cash, over the recovery period of the asset.

Explanation of Provision

The committee bill repeals the provision of present law (sec. 118(b)) that provides for the treatment of contributions in aid of construction received by a corporate regulated public utility to be treated as a contribution to the capital of the utility.

The committee intends that the effect of the change is to require that a utility report as an item of gross income the value of any property, including money, that it receives to provide, or encourage of the provision of, services to or for the benefit of the person transferring the property. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.

The committee intends that a utility include in gross income the value of the property received regardless of whether the utility had a general policy, stated or unstated, that requires or encourages certain types of potential customers to transfer property, including money, to the utility while other types of potential customers are not required or encouraged to make similar transfers. If members of a group making transfers of property are favored over other members of the same general group not making such transfers, the fact that the contributing members of the group may not be favored over the members of other groups in the receipt of services will not prevent the inclusion of the value of the transfer in the gross income of the utility. For instance, where a utility generally requires developers of multiple tracts of residential housing to transfer property to the utility in order to obtain service, but does not require such a transfer from individual homeowners, the fact that both groups will receive service without preference of one group over the other will not prevent the utility from being required to include in gross income the value of the property received from the developers. Where all members of a particular group make transfers of property to the utility, normally it will be assumed that such transfers are to encourage the provision of services, despite the absence of any formal policy requiring such transfers, unless it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers.

The person transferring the property will be considered as having been benefitted if he is the person who will receive the services, an owner of the property that will receive the services, a former owner of the property that will receive the services, or if he derives any benefit from the property that will receive the services.

Thus, a builder who transfers property to a utility in order to obtain services for a house that he was paid to build will be considered as having benefitted from the provision of the services. This will be the case despite the fact that the builder may never have had an ownership interest in the property and may make the transfer to the utility after the house has been completed and accepted.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $——— in 1986, $——— in 1987, $——— in 1988, $——— in 1989, and $——— in 1990.

B. Timber Provisions [51]

1. Capital Gains Rules Applicable To Timber (Sec. 912 of the bill and sec. 631 of the Code)

Present Law

Royalty income received by the holder of a timber royalty interest qualifies for long-term capital gain treatment, if the timber has been held for more than six months before disposition (sec. 631(b)). Also, the owner of timber (or a contract right to cut timber) may elect to treat the cutting of timber as a sale or exchange qualifying for long-term capital gain treatment, even though the timber is sold or used in the taxpayer's trade or business (sec. 631(a)). This provision also generally requires that the timber (or contract right) be held for more than six months prior to cutting.

Reasons for Change

The committee believes that the income from goods which are produced for sale in the ordinary course of business should be taxed as ordinary income. Only if a particular need for incentive treatment is identified should capital gains treatment be made available. The committee believes that the growing of timber by individuals on non-Federal lands is an activity with such a need at this time.

Explanation of Provision

The bill repeals the capital gains treatment of present law as it relates to timber royalties and cutting income; except for gains reported by natural persons, by their estates, and by trusts all the beneficiaries of which are natural persons; as long as the timber was not grown on Federal lands. The gains from timber of taxpayers other than those listed above, as well as the gains from timber of all taxpayers where such gains are attributable to timber grown on Federal lands, are to be reported as ordinary income.

The bill allows gains from timber, other than timber grown on Federal lands, which are reported at the individual level and which currently qualify for capital gains treatment to continue to so qualify. Thus, an individual partner's distributive share of such gains may be reported as capital gains by the individual, despite the fact that the partnership also has corporate partners which will not be able to report their distributive shares as capital gains.

The bill provides for a three year transition period from capital gains to ordinary income treatment for gains from timber in the

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[51] For a description of 5-year amortization of certain timber preproductive expenditures (sec. 911 of the bill), see part A.4., above.

case of corporations with respect to timber not on Federal lands. Amounts which are treated as capital gains by present law, but which are not to be treated as capital gains by the committee bill, will be eligible for limited capital gains benefits during the transition period. A special alternative corporate capital gains tax rate of 30 percent for taxable years beginning or ending in 1986, 31 percent for taxable years beginning in 1987 and 32 percent for taxable years beginning in 1988 is provided (sec. 302 of the bill).

The committee bill provides that the growing of trees bearing fruits, nuts, or other agricultural crops, which are grown or acquired for the purpose of exploiting such fruits, nuts, or crops, as well as the growing of Christmas or other ornamental trees, are not to be considered as the growing of timber for this purpose. Such trees are considered as agricultural products for the purposes of the committee bill and that the growing of such trees will be taxed according to the rules for agricultural products and farming businesses.

Effective Date

Subject to the three year transition rule described above, the provision is effective for amounts taken into account after December 31, 1985.

2. Amortization of Reforestation Expenditures (sec. 911 of the bill and sec. 194 of the Code)

Present Law

Taxpayers may elect to amortize over a 7-year period up to $10,000 for reforestation expenditures incurred in each taxable year. (A 10-percent tax credit also is allowable for these expenditures.)

Reasons for Change

The committee is concerned that certain Federal income tax provisions may be affecting prudent timber production decisions adversely. The committee believes that repealing these special incentives will encourage more prudent timber management decisions.

Explanation of Provision

The bill repeals the provision allowing certain reforestation expenditures to be amortized over a 7-year period.

Effective Date

This provision is effective for expenditures incurred after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1 million in 1986, $11 million in 1987, $23 million in 1988, $24 million in 1989, and $26 million in 1990.

C. Provisions Relating to Agriculture

1. Special Expensing and Amortization Provisions Affecting Agriculture (secs. 921-22 of the bill and secs. 175, 180, and 182, of the Code)

Present Law

Expenditures for soil and water conservation

A taxpayer may elect to deduct (i.e., expense) certain expenditures for the purpose of soil or water conservation that would otherwise be added to his or her basis in the land on which the conservation activity occurs (sec. 175). Deductible expenditures include amounts paid for items such as grading, terracing, and contour furrowing, the construction of drainage ditches, irrigation ditches, dams and ponds, and the planting of wind breaks. Also, assessments levied by a soil or water conservation drainage district are deductible under this provision to the extent those expenditures would constitute deductible expenditures if paid directly by the taxpayer.

The cost of acquiring or constructing machinery or facilities that is depreciable may not be expensed. In the case of depreciable items such as irrigation pumps, concrete dams, or concrete ditches, the taxpayer is allowed to recover his or her cost only through cost recovery allowances and only if he or she owns the asset. Certain depreciable assets also are eligible for the regular 10-percent investment credit.

Certain costs incurred in connection with soil and water conservation are deductible as trade or business expenses without regard to section 175. For example, interest expenses and property taxes are deductible as current expenses. Similarly, the costs of repairs to a complete soil or water conservation structure are deductible as current expenses. Certain other capital expenditures made primarily to produce an agricultural crop are deductible expenses (secs. 180 and 182), but are not treated as soil or conservation expenditures under section 175, because such expenditures only incidentally may conserve soil.

The deduction for soil and water conservation expenditures under section 175 is limited in any one year to 25 percent of the gross income derived by the taxpayer from farming. Any excess amount is carried forward to succeeding taxable years.

Expenditures for fertilizer and soil conditioning

A taxpayer engaged in the business of farming may elect to expense otherwise capitalized amounts that are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (sec. 180). For this purpose, land is used in farming

if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.

Expenditures for clearing land

A taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as currently deductible expenses (sec. 182). For any taxable year, this deduction may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming.

Reasons for Change

The committee is concerned that certain Federal income tax provisions may be affecting prudent farming decisions adversely under present law. The committee believes that to the extent possible, the tax code should be neutral with respect to these business decisions. To eliminate tax biases, therefore, the committee determined that the special farming and forestry expensing, amortization, and credit provisions should be repealed or restricted.

Explanation of Provisions

a. Soil and water conservation expenditures

The bill limits the soil and water conservation expenditures that may be deducted currently to amounts incurred that are consistent with a conservation plan approved by the Soil Conservation Service (SCS) of the Department of Agriculture. If there is no SCS conservation plan for the area in which property to be improved is located, amounts incurred for improvements that are consistent with a plan of a State conservation agency are deemed to satisfy the Federal standards. Finally, the bill provides that expenditures for general earth moving, draining, and/or filling of wetlands, and for preparing land for installation and/or operation of a center pivot irrigation system may not be deducted under this special expensing provision.

b. Expenditures for fertilizer and soil conditioning

The bill repeals the provision allowing expenditures for fertilizer and soil conditioning to be deducted currently. Thus, such expenses would be added to the basis of the land on which the activity occurs. However, expenses that would be deductible as ordinary and necessary business expenses absent the special rule of section 180 (e.g., fertilizer or lime that must be applied every year and that are incidental to crop production) continue to be currently deductible.

c. Expenditures for clearing land

The bill repeals the provision allowing expenditures for clearing land in preparation for farming to be deducted currently rather than added to the basis of the land on which the activity occurs. The committee wishes to clarify, however, that routine brush clear-

ing and other ordinary maintenance activities related to property already used in farming continue to be deductible currently to the extent the expenditures constitute ordinary and necessary business expenses of the taxpayer. (*See*, sec. 162.)

Effective Date

These provisions apply to expenditures incurred after December 31, 1985.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $664 million in 1986, $948 million in 1987, $102 million in 1988, $105 million in 1989, and $108 million in 1990.

2. Dispositions of Converted Wetlands and Highly Erodible Croplands (sec. 923 of the bill and new sec. 1257 of the Code)

Present Law

Gain realized on the sale or other disposition of a capital asset is subject to tax at preferential rates. The term capital asset does not include property used in a taxpayer's trade or business that is of a character subject to depreciation (sec. 1221(2)). However, gain from the sale of such property ("section 1231 assets") may be taxed on the same basis as gain from the sale of a capital asset if gains on all sales of section 1231 assets during a taxable year exceed losses on such sales.

If losses from the sale or exchange of section 1231 assets during a taxable year exceed the gains from such sales or exchanges, the net losses are treated as ordinary losses. Ordinary losses are deductible in full for tax purposes, while deductions for capital losses are subject to limitations.

Reasons for Change

The committee is concerned about the adverse environmental impact of the conversion of the nation's wetlands and erodible lands to farming uses, and wishes to discourage such conversions.

Explanation of Provision

The bill provides that any gain realized on the disposition of "converted wetland" or "highly erodible cropland" will be treated as ordinary income, and any loss on the disposition of such property will be treated as long-term capital loss. For this purpose, the term "converted wetland" means land (1) that is converted wetland within the meaning of section 1201(2) of H.R. 2100 (99th Congress) as passed by the House of Representatives, and (2) that is held by the person who originally converted the wetland, by a person who uses the land for farming for any period of time following the conversion, or by a person whose adjusted basis in the property is determined by reference to the basis of a person in whose hands the

property was converted wetland.[52] In general, H.R. 2100 defines converted wetland as land that has been drained or filled for the purpose of making the production of agricultural commodities possible, if the production would not have been possible but for such action.

The term "highly erodible cropland" means any highly erodible cropland as defined in section 1201(6) of H.R. 2100 (99th Congress) that is used by the taxpayer at any time for farming purposes other than the grazing of animals. In general, H.R. 2100 defines highly erodible cropland as land that (1) is classified by the Department of Agriculture as class IVe, VI, VII, or VIII land under its land capability classification system, or that would have an excessive average annual rate of erosion in relation to the soil loss tolerance level, as determined by the Secretary of the Agriculture.

Effective Date

The provision is effective for dispositions after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amounts.

3. Netting of Gains and Losses by Cooperatives (Sec. 924 of the bill and secs. 521 and 1388 of the Code)

Present Law

In general, present law permits any corporation operating on a cooperative basis, including a so-called tax-exempt farmers' cooperative, to exclude from taxable income amounts paid as patronage dividends or certain other amounts paid or allocated to members, to the extent of net income generated from transactions with members (sec. 1382). In addition, tax-exempt farmers' cooperatives generally may exclude such amounts to the extent of all net income, and also are granted a deduction to a limited extent for dividends paid on common stock (sec. 521).

Patronage dividends are amounts paid or allocated by the cooperative to a patron (a) based on the quantity or value of business done with or for such patron, (b) under a pre-existing obligation of the cooperative to distribute such amounts, and (c) which are determined by reference to the net earnings of the organization from business done with or for its patrons (sec. 1388(a)).

In general, a tax-exempt farmers' cooperative is specifically defined in section 521(b) as a farmers', fruit growers', or like association organized and operated on a cooperative basis either for the purpose of marketing the products of its members or others, or for the purpose of purchasing supplies and equipment for members or other persons. In the case of a tax-exempt farmers' cooperative that markets products, the proceeds of sale by the cooperative less

[52] Thus, land that has been converted could become eligible for section 1231 treatment in the hands of, for example, a subsequent purchaser or legatee, provided the purchaser or legatee has used the property only for nonfarming purposes.

necessary expenses of sale must be turned over to the members or other producers on the basis of the quantity or value of the products furnished; in the case of a tax-exempt farmers' cooperative that purchases supplies and equipment, the purchased goods must be made available at the cooperative's cost, plus necessary expenses.

The United States Tax Court has addressed certain issues related to the netting of earnings and losses of different allocation units by a cooperative in three different factual settings. In *Associated Milk Producers* v. *Comm'r*, 68 T.C. 729 (1977), the Internal Revenue Service asserted that a cooperative was not entitled to carry over a net operating loss deduction where doing so would offset patronage income in a taxable year with losses from a prior year. However, the court held that the carryover was allowed in circumstances that the court considered reasonable for management to offset the income and loss. In *Ford-Iroquois FS, Inc.* v. *Comm'r*, 74 T.C. 1213 (1980), the Internal Revenue Service asserted that a non-exempt cooperative was not entitled to carry over a net operating loss deduction to the extent that losses from prior years' marketing and storage operations would offset patronage income from farm supply operations. However, the court allowed the carryover, noting that there was substantial overlap of the patrons of the two operations and the allocations otherwise were fair. In *Lamesa Cooperative Gin* v. *Comm'r*, 78 T.C. 894 (1982), the Internal Revenue Service asserted that an exempt cooperative was required to account separately for its purchasing and marketing operations, and included in the cooperative's income certain patronage dividends to the extent income from the cooperative's purchasing operation offset losses from its marketing operation. The court nevertheless held that the cooperative could net the income and loss where the purchasing operation was so small that it would have been unreasonable to account for it separately.

Reasons for Change

It has been asserted that netting gains and losses from purchasing and marketing operations or from operations in different products or geographic areas may be inconsistent with the statutory definition of a tax-exempt farmers' cooperative, particularly if management has broad discretion over decisions regarding such netting, and members of the cooperative are not informed of the practice. It has also been asserted that the statutory requirement that the amount of a patronage dividend must be determined on the basis of the net earnings of cooperative may not be met where the net earnings are not computed separately for each allocation unit, i.e., where the cooperative computes its net earnings by netting the earnings and losses of different allocation units.

The committee believes that netting of gains and losses is an appropriate practice for both tax-exempt farmers' cooperatives and other cooperatives. In addition, the committee believes that, in the future, cooperatives that engage in the practice of netting should be required to notify their members of the practice.

Explanation of Provision

Netting earnings and losses

The committee bill provides that a cooperative is not ineligible for treatment as a tax-exempt farmers' cooperative if it offsets certain earnings and losses in determining any amount available for distribution to patrons. For this purpose, the losses that are attributable to one or more allocation units (including a loss that is carried over from another year), may be offset against earnings of one or more other allocation units, but only to the extent such earnings and losses are derived from business done with or for patrons. Such patronage earnings and losses may be offset without regard to whether the allocation units whose earnings or losses are offset are functional, divisional, departmental, geographic, or otherwise.

The committee bill also provides that the offsetting of earnings and losses, as described above, may at the option of the cooperative be used for determining the net earnings of the cooperative for the purpose of paying patronage dividends. Moreover, the committee bill provides that if a cooperative acquires the assets of another cooperative in a transaction specified in section 381(a), the acquiring cooperative may offset losses of one or more of the allocation units of the acquiring or the acquired cooperative against earnings of the the acquired or acquiring cooperative, respectively, to the extent that (a) the earnings that are offset are properly allocable to periods after the date of acquisition, and (b) such earnings and losses could have been offset if derived from allocation units of the same cooperative.[53]

The committee bill contains no provision that addresses the issue of whether nonpatronage losses may offset patronage earnings, and the committee intends that no inference should be drawn from the absence of any such provision. The committee, however, approves of the result in the case of *Farm Service Coop.* v. *Comm'r*, 619 F.2d 718 (8th Cir. 1980), which held that, in the computation of taxable income and in the determination of net earnings for the purpose of paying patronage dividends, a nonexempt cooperative may not offset income from nonpatronage business with losses from patronage business. The committee otherwise intends that nothing in the bill will affect the rules of present law relating to the manner in which a cooperative computes its taxable income, including the extent to which net operating loss deductions are available.

Notice requirement

The committee bill provides that a cooperative that offsets earnings and losses must notify members who may have been affected by such offsetting. The committee intends that all such patrons must be notified regardless of whether any patronage dividends were in fact distributed, so long as the offsetting may have affected any amount that the patron may otherwise have received in the current or future year, whether in the form of patronage dividend, per-unit retain allocation, notice of allocation, or any other amount

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[53] Where an acquisition takes place during a taxable year, the committee intends that the cooperative's earnings for the entire year would be allocated pro rata between the pre-acquisition and post-acquisition periods.

distributed or allocated to the member. The notice must be sent to such members by no later than the 15th day of the 9th month following the close of the cooperative's taxable year.

The notice must state that the cooperative has offset earnings and losses of one or more of its allocation units and that such offset may have affected the amount that is being distributed to the patron. The notice must state generally the identity of the offsetting allocation units. The notice also must state briefly what rights, if any, that such patron may have to additional financial information of such organization under the terms of its charter, articles of incorporation, bylaws, and any provision of law. Although the notice must specify the identity of the offsetting allocation units (but not which unit's earnings were offset by which unit's losses), the cooperative is not required to disclose in the notice any detailed or specific data that it considers to be commercially sensitive. The committee intends that the cooperative's determination of what information is considered commercially sensitive for this purpose must be reasonable.

Failure to comply with this notice requirement, upon notification of such failure by the Secretary of the Treasury, will require a cooperative to provide a notice that meets the statutory requirements to all patrons who previously received the inadequate notice, but will have no other tax consequences for the cooperative. A cooperative that does not offset gains and losses of any allocation units will not be subject to the notice requirement. The committee intends that a cooperative that merely "pools" within a single allocation unit will not be subject to the notice requirement.

Effective Date

The provisions of the committee bill relating to cooperatives generally are effective for taxable years beginning after December 31, 1962. However, the provision relating to the notification of cooperative members is effective for taxable years beginning after the date of enactment of the bill.

Revenue Effect

The provision is estimated to have no effect on budget receipts.

4. Treatment of Certain Plant Variety Protection Certificates as Patents (sec. 925 of the bill and sec. 1235 of the Code)

Present Law

A sale or exchange of all substantial rights to a patent by the individual whose efforts created the patent generally produces long-term capital gain (sec. 1235). Treasury Department regulations define the term "patent" for this purpose as any patent granted under Title 35 of the United States Code.

The Department of Agriculture administers a program pursuant to the Plant Variety Protection Act of 1970 (84 Stat. 1542, 7 U.S.C. secs. 2321 et. seq.), which extends protections to developers of sexually propagated plant varieties similar to those provided to patent holders.

Reasons for Change

The committee believes that certificates issued under the Plant Variety Protection Act are sufficiently similar to patents that they should receive the same treatment as patents for purposes of section 1235.

Explanation of Provision

The bill provides that, for purposes of section 1235, the term patent includes a certificate of plant variety protection issued under section 81 of the Plant Variety Protection Act of 1970 (7 U.S.C. sec. 2481).

Effective Date

The provision is effective for dispositions after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by a negligible amount.

TITLE X. INSURANCE PRODUCTS AND COMPANIES

A. Insurance Policyholders

1. Interest on Installment Payments of Life Insurance Products (sec. 1001 of the bill and sec. 101(d) of the Code)

Present Law

Amounts paid by an insurance company to the beneficiary of a life insurance contract by reason of the death of an insured individual generally are not includible in gross income. Under certain life insurance contracts, the insurer may agree to hold the amounts that it would otherwise pay on the death of the insured, and pay the life insurance proceeds at a later date.

If the insurer pays the insurance proceeds to a beneficiary in a series of payments after the death of the insured, a prorated amount of each payment is treated as a nontaxable payment of the death benefit, with the remainder of the payment generally being includible in gross income. However, the first $1,000 in excess of the amount treated as a payment of the death benefit received by a surviving spouse in any taxable year is excludable from gross income.

Reasons for Change

The amount received by a beneficiary of a life insurance contract in excess of the prorated amount deemed to be a payment of the death benefit represents a payment made by the insurance company for the use of the beneficiary's money, i.e., the unpaid death benefit. The committee believes that this amount is comparable to interest paid by other financial institutions for the use of depositors' money, and should be taxed in the same manner.

Explanation of Provision

Under the bill, all amounts paid to any beneficiary of a life insurance policy at a date later than the death of the insured are included in gross income to the extent that the amount paid exceeds the amount payable as a death benefit. The exclusion from the gross income of the surviving spouse of the first $1,000 in excess of the amount payable as the death benefit is repealed.

Effective Date

This provision applies to amounts received with respect to deaths occurring after December 31, 1985.

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2. Deduction for Nonbusiness Casualty Losses (sec. 1002 of the bill and sec. 165(h) of the Code)

Present Law

A taxpayer generally may deduct a loss sustained during the taxable year if the loss is not compensated by insurance or otherwise (sec. 165(a)). For property not connected with a trade or business or a transaction entered into for profit, losses are deductible only if they arise from "fire, storm, shipwreck, or other casualty, or theft." These personal casualty losses are deductible only to the extent that each casualty loss exceeds $100, and to the extent that all casualty losses for the year exceed 10 percent of the taxpayer's adjusted gross income (sec. 165(h)). Certain courts have ruled that a taxpayer whose loss was covered by an insurance policy could nevertheless deduct the loss if the taxpayer decided not to file a claim under the terms of the insurance policy. See *Hills* v. *Commissioner*, 691 F.2d 997 (11th Cir. 1982); *Miller* v. *Commissioner*, 733 F.2d 399 (6th Cir. 1984).

Reasons for Change

The deduction for personal casualty losses should be allowed only when a loss is attributable to damage to property that is caused by one of the specified types of casualties. Where the taxpayer has the right to receive insurance proceeds that would compensate for the loss, the loss suffered by the taxpayer is not damage to property caused by the casualty. Rather, the loss results from the taxpayer's personal decision to forego making a claim against the insurance company. The committee believes that losses resulting from a personal decision of the taxpayer should not be deductible as a casualty loss.

Explanation of Provision

Under the bill, a taxpayer is not permitted to deduct a casualty loss for damages to property not used in a trade or business or in a transaction entered into for profit unless the taxpayer files a timely insurance claim with respect to damage to that property. This requirement applies to the extent any insurance policy would provide reimbursement for the loss in whole or in part. If a policy would provide compensation for the loss, it is immaterial whether the taxpayer is the primary beneficiary of the policy so long as it is within the control of the taxpayer whether to file a claim.

Effective Date

The provision applies to losses sustained in taxable years beginning after December 31, 1985.

3. Exclusion From Income From Structured Settlements Limited to Cases Involving Physical Injury (sec. 1003 of the bill and sec. 130 of the Code)

Present Law

Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation to pay the periodic payments. The portion of the amount received by that third party for agreeing to the assignment that is used to purchase assets to fund the liability is not included in that party's income. This special treatment of the structured settlement company applies only if the obligation assigned to it is a liability to make periodic payments as damages on account of personal injury or sickness.

Reasons for Change

The present treatment of structured settlements has the overall effect of exempting from taxation investment income earned on assets used to fund the periodic payment of damages. The committee believes that this effect is inappropriate where the injury did not involve physical injury or physical sickness. In cases involving personal nonphysical injuries, the committee concludes that the investment income earned on assets used to fund the damage payment should be subject to taxation.

Explanation of Provision

The bill amends present law to limit "qualified assignments" to those assignments requiring the payment of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant. Damages on account of a claim for wrongful death arising from physical injury or sickness are also included. The provision is intended to clarify that claims for damages for torts other than physical injury and physical sickness (such as invasion of privacy, for example) are not included. Thus, for example, if a structured settlement company receives compensation in consideration of its assumption of the obligation to make periodic payments of damages on account of the defamation of a third party, the full amount of the consideration received is included in gross income.

Effective Date

The amendment made by this provision applies to assignments entered into after December 31, 1985.

4. Life Insurance Policyholder Loans (sec. 264 of the Code)

Present Law

Under present law, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry certain life insurance, endowment or annuity contracts pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of increases in the cash value of the contract, unless the requirements of certain exceptions to this disallowance rule are satisfied (sec. 264). Among the exceptions is a provision that the disallowance rule generally does not apply if no part of four of the annual premiums due during the seven year period (beginning with the date the first premium on the contract was paid) is paid under a systematic borrowing plan by means of indebtedness (sec. 264(c)(1)) (known as the "four out of seven rule").

In the case of a single premium contract, however, the rule of present law is that no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (sec. 264(a)(2)). Single premium contracts include contracts where substantially all of the premiums are paid within four years from the date on which the contract is purchased, or contracts where an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. This disallowance rule applies whether or not there is systematic direct or indirect borrowing of increases in the cash value of the contract, generally without exception. Thus, interest paid or accrued on indebtedness incurred or continued to purchase or carry any contract that is treated as a single premium contract is not protected by the four out of seven rule. In addition, indebtedness secured by a single premium life insurance contract is generally subject to the rule of section 264(a)(2). Section 264(a)(2) also applies to all contracts other than those where the nonpayment of premiums would cause the policy to lapse.

Reasons for Change

It has come to the committee's attention that some practitioners may be taking the position that some single premium contracts are eligible for the "four out of seven" exception to the disallowance rule, or that borrowing with respect to a single premium contract is deductible under present law. In addition, it has come to the committee's attention that some practitioners may characterize a universal life insurance policy as a contract that provides for annual premiums due for purposes of the four out of seven rule. The committee believes it is appropriate to restate and clarify the provision of present law disallowing interest deductions with respect to borrowings incurred or continued in connection with single premium life, endowment or annuity contracts.

Explanation of Provision

The rule of present law regarding the disallowance of a deduction for any amount paid or accrued on indebtedness incurred or

continued to purchase or carry a single premium life insurance, endowment or annuity contract is restated.

Revenue Effect of Part A

These provisions are estimated to increase fiscal year budget receipts by less than $25 million for 1986-1990.

B. Life Insurance Companies

1. Special Life Insurance Company Deduction (sec. 1011 of the bill and sec. 806 of the Code)

Present Law

A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI) and certain other income. A life insurance company is allowed a special deduction in computing LICTI equal to 20 percent of the income from insurance businesses that otherwise would be subject to taxation (sec. 806).

Reasons for Change

The 20 percent special life insurance company deduction was enacted in 1984 because it was believed necessary to ameliorate the sudden, substantial increase in the tax liability of life insurance companies. This increase occurred as a result of the change from the three-phase taxable income computation that was in effect previously to a single-phase system consistent with generally applicable corporate tax law.

In light of the overall reduction of corporate tax rates contained in other provisions of the bill, the committee believes that the 20 percent special life insurance company deduction is no longer necessary. Despite the elimination of this special deduction, the maximum marginal tax rate applicable to life insurance companies will decline under the bill.

Explanation of Provision

The special life insurance company deduction is repealed.

Effective Date

This provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $401 million in 1986, $695 million in 1987, $748 million in 1988, $802 million in 1989, and $860 million in 1990.

2. Taxation of Tax-Exempt Organizations Engaged in Insurance Activities (sec. 1012 of the bill and sec. 501(m) of the Code)

Present Law

Present law (sec. 501(c)) specifies various standards that an organization must meet in order to qualify for exemption from Federal

income taxation. These standards vary depending on the basis on which the entity is seeking exemption. Certain activities performed by an organization may make it ineligible for tax exemption.

In addition, an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes. Specific exclusions from unrelated trade or business taxable income are provided for certain types of income, including rents, royalties, dividends, and interest, and certain other income except income derived from "debt-financed property."

Charitable organizations.—An organization is exempt from Federal income tax if it is a corporation, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, educational, or certain other purposes (sec. 501(c)(3)). An organization is not considered organized or operated exclusively for one or more of the exempt purposes unless it serves a public rather than a private interest.[1]

The providing of insurance benefits by an organization otherwise described in sec. 501(c)(3) generally is considered a commercial activity that does not meet the requirements for tax-exempt status. For example, if two or more unrelated tax-exempt organizations pool funds for the purpose of accumulating and holding funds to be used to satisfy malpractice claims against the organizations, the organization holding the pooled funds is not entitled to tax exemption because the activity (i.e., the provision of insurance) is inherently commercial in nature.[2]

Nevertheless, at least one major organization, which provides life insurance and annuities to employees of tax-exempt educational institutions, has been recognized as a charitable organization by the IRS.[3]

Social welfare organizations.—An organization is entitled to tax exemption if it is operated exclusively for the promotion of social welfare.[4] At least one major health insurance provider has been treated as a tax-exempt social welfare organization. Other organizations providing insurance have been denied tax-exempt status as social welfare organizations. For example, an insurance trust set up to provide group life insurance for members has been held not to be tax-exempt because the trust was organized only for the benefit of its members, which was a limited class.[5] Further, if the bene-

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[1] Treas. Reg. sec. 1.501(c)(3)-1(d)(1).

[2] See, e.g., GCM 39122, CC:EE-36-82 (January 25, 1984); GCM 39003, CC:EE-37-82 (June 24, 1983).

[3] The Office of Chief Counsel of the IRS was asked to review a proposal to revoke the exempt status of this organization, which is engaged in providing pension and insurance benefits to employees of tax-exempt educational institutions. GCM 34701, CC:EI 3589 (undated). The Chief Counsel's office stated that two primary factors supported the revocation of the organization's exempt status. First, the organization is similar to a mutual insurance company because most of the operating expenses are now covered by premium payments, rather than grants from another tax-exempt organization. This could provide the basis for arguing that the organization no longer accomplishes its objectives in a charitable manner. Second, the organization's activities no longer benefit a distressed class of individuals and the organization's only basis for exemption would be that it advances education by enabling participating educational institutions to provide retirement programs to its employees at a cost lower than the cost would be if the institutions ran their own programs or purchased insurance from commercial insurers. However, the Chief Counsel's office did not administratively revoke the organization's tax-exempt status.

[4] Sec. 501(c)(4).

[5] N.Y. State Association of Real Estate Boards Insurance Fund v. Comm'r, 54 TC 1325 (1970).

fit from an organization is limited to that organization's members, except for some minor and incidental benefit to the community as a whole, the organization is not operated exclusively for the promotion of social welfare.[6]

Fraternal beneficiary societies.—A fraternal beneficiary society, order, or association (sec. 501(c)(8)) is entitled to tax exemption if it operates under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

Reasons for Change

The committee is concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax exempt status is inappropriate. The committee believes that the tax-exempt status of organizations engaged in insurance activities provides an unfair competitive advantage to these organizations. The committee further believes that the provision of insurance to the general public at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial.

In addition, the availability of tax-exempt status under present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in sections 501(c)(3) or (4). This group of organizations is now among the largest health care insurers in the United States. Other tax-exempt charitable and social welfare organizations engaged in insurance activities also have a competitive advantage over commercial insurers who do not have tax-exempt status.

The committee is also concerned that some tax-exempt fraternal beneficiary societies described in section 501(c)(8) of the Code engage in large-scale insurance activities which may be inherently commercial in nature, and that such organizations may derive a competitive advantage from their tax-exempt status.

Explanation of Provision

Under the bill, an organization described in sections 501(c)(3) and (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, no substantial part has the meaning given to it under present law applicable to such organizations. See, e.g., *Haswell v. U.S.*, 500 F.2d 1133 (Ct. Cl. 1974); *Seasongood v. Comm'r*, 1227 F.2d 907 (6th Cir. 1955); see also sec. 501(h).

In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business (sec. 513) but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business

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[6] Rev. Rul. 75-199, 1975-1 CB 160.

activity is taxed under the rules relating to insurance companies (Subchapter L).

For this purpose, commercial-type insurance generally is any insurance of a type provided by commercial insurance companies. The bill provides that the issuance of annuity contracts is treated as providing insurance. The activity of providing insurance or annuities under a qualified pension plan (described in sec. 401(a)) is not the activity of providing commercial-type insurance, because such plans are not charitable or social welfare organizations to which the bill applies.

Several exceptions are provided to the definition of commercial-type insurance. Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. See, e.g., Rev. Rul. 71-529, 1971-2 C.B. 234 (relating to the meaning of substantially below cost). A class of charitable recipients refers to a group of recipients that would constitute a charitable class under present law. Commercial-type insurance also does not include health insurance provided by a health maintenance organization that is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care. Section 501(m) of the Code, as added by the bill, is not intended to alter the tax-exempt status of an ordinary health maintenance organization that provides health care to its members predominantly at its own facility through the use of health care professionals and other workers employed by the organization. Similarly, organizations that provide supplemental health maintenance organization-type services (such as dental services) would not be affected if they operate in the same manner as a health maintenance organization.

In addition, commercial-type insurance does not include property and casualty insurance (such as fire insurance) provided directly or through a wholly-owned corporation by a church or convention or association of churches for the church or convention or association. For this purpose, property and casualty insurance is not intended to include life insurance or accident and health insurance (whether or not cancelable). This exception is not intended to apply if the insurance is provided not only to the church, convention or association, but also to other persons.

In the case of activities of Blue Cross and Blue Shield and their affiliates with respect to high risk individuals and small groups, the bill authorizes the Treasury Department to issue regulations providing for special treatment to such organizations. Congress intends that this special benefit be provided in connection with the unique activities (such as open enrollment) of Blue Cross and Blue Shield and their affiliates for high risk individuals and small groups, so that such activities (to the extent not engaged in by commercial insurers) are not overburdened by tax costs and therefore reduced. The special treatment would not be available to the extent the activities are required by applicable law. Thus, for example, if applicable law requires companies issuing health insurance policies to provide coverage to a specified group of high-risk individuals, Blue Cross and Blue Shield organizations should not be accorded any special treatment with respect to that activity.

With respect to fraternal beneficiary societies engaged in insurance activities, the committee re-emphasizes the requirement of present law that such tax-exempt organizations maintain an active lodge system. The bill also requires that the Treasury Department audit and study fraternal beneficiary organizations (described in sec. 501(c)(8)) that received gross insurance premiums in excess of $25,000,000 in taxable year 1984. The committee intends that the use of revenues from insurance activities of such organizations be studied. The Treasury has authority under the bill to require the furnishing of information necessary to conduct the audit and study. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation no later than January 1, 1988, so that Congress may consider the recommendations and take such action regarding the tax treatment of fraternal beneficiary societies engaged in insurance activities as is appropriate.

Effective Dates

The provision is effective for taxable years beginning after December 31, 1985. A special rule for Mutual of America provides that this provision shall not apply with respect to that portion of its business attributable to pension business. Another special rule for Teachers Insurance Annuity Association-College Retirement Equities Fund provides that this provision does not apply to taxable years beginning before January 1, 1988, with respect to that portion of its business attributable to pension business. For that purpose, the bill provides that pension business means administering qualified pension plans (sec. 401(a) or 403(a)), tax-sheltered annuities (sec. 403(b)), unfunded deferred compensation plans of State and local governments (sec. 457), and individual retirement arrangements (IRAs) (sec. 408).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $222 million for 1986, $453 million for 1987, $465 million for 1988, $440 million for 1989 and $404 million for 1990.

3. Operations Loss Deduction of Insolvent Companies (sec. 1013 of the bill)

Present Law

Prior to 1984, life insurance companies were permitted to exclude from taxable income 50 percent of the excess of their gain from operations over their taxable investment income. In addition, they were allowed certain special deductions for nonparticipating contracts and for accident and health insurance and group life insurance contracts. The amounts deducted under these provisions were added to a deferred tax account known as the policyholders surplus account ("PSA"). The allowance of these special deductions, and the establishment of a PSA, were intended to provide a cushion of assets to protect the interests of the policyholders.

The deferral of tax on amounts held in the PSA is ended if the amounts are distributed to shareholders. In certain circumstances, amounts may be required to be distributed from the PSA (i.e., the deferral of tax on such amounts is ended) if the PSA becomes too large in relation to the scope of the company's current operations. The deferral of tax on amounts in the PSA also may end if the company ceases to be taxed as a life insurance company. The amounts included in income as a result of ending deferral on amounts in the PSA cannot be offset by the company's loss from operations or loss carryovers.

The Life Insurance Company Tax Act of 1984 repealed the deductions that gave rise to the additions to the PSA. However, a stock life insurance company is required to include in income any amount deemed to be distributed from its existing PSA.

Reasons for Change

The committee believes that, in case of contraction of the insurance company's business due to insolvency on November 15, 1985, and the court-ordered liquidation of the company, it is appropriate to permit the otherwise unusable loss from operations or operations loss carryovers to offset the previously deferred amounts in the PSA.

Explanation of Provision

Under the bill, a life insurance company is permitted to apply its current loss from operations and its unused operations loss carryovers against the increase in its taxable income attributable to the amount distributed from its PSA if certain conditions are satisfied. First, the company must have been insolvent on November 15, 1985. Second, the company must be liquidated pursuant to the order of a court of competent jurisdiction in a title 11 or similar case. Third, as a result of the liquidation, the company's tax liability would be increased due to distributions from the PSA. Under the provision, no carryover of any loss from operations of the company arising during or prior to the year of liquidation may be used in any taxable year succeeding the liquidation year (regardless of whether the amount of the loss exceeds the amount of the distribution from the PSA).

Effective Date

The provision applies to liquidations on or after November 15, 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts for by a negligible amount.

C. Property and Casualty Insurance Company Taxation

1. Inclusion in Income of 20 Percent of Unearned Premium Reserve (sec. 1021 of the bill and sec. 832(b) of the code)

Present Law

Under present law, the income of a property and casualty insurance company [7] (whether stock or mutual) includes its underwriting income or loss and its investment income or loss, as well as gains and other income items.[8] Underwriting income means premiums earned on insurance contracts during the year, less losses incurred and expenses incurred (sec. 832(b)(3)). To determine premiums earned, the increase in unearned premiums during the year is deducted from gross premiums (sec. 832(b)(4)(B)). This treatment of unearned premiums generally reflects accounting conventions imposed under applicable law [9] and corresponds to the establishment of reserves for unearned premiums.

Unearned premiums of a property and casualty insurance company include its life insurance reserves (including annuity reserves), if any. Generally, the deduction for the reserve for unearned premiums effects a deferral of the premium income attributable to insurance coverage in a future year.

Property and casualty insurers may also deduct expenses incurred during the taxable year (sec. 832(b)(3)). Expenses incurred generally means expenses shown on the annual statement approved by the National Association of Insurance Commissioners. Expenses incurred are calculated by adding to expenses paid during the year the difference between unpaid expenses at the end of the current year and unpaid expenses at the end of the preceding year (sec. 832(b)(6)). Expenses incurred ordinarily include premium acquisition expenses. Expenses, to be deductible, must constitute ordinary and necessary trade or business expenses within the meaning of section 162 (sec. 832(c)(1)), although this rule does not determine the time when the deduction is allowed.

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[7] The use of the term "property and casualty insurance company" is intended to refer to all those taxpayers subject to tax under Part II or III of subchapter L of the Code.

[8] Under present law, mutual companies with certain gross receipts less than $150,000 are exempt from tax (sec. 501(c)(15)), and other rules set forth special rates, deductions and exemptions for mutual companies with certain categories and amounts of income (sec. 821 et seq.). In addition, mutual companies are allowed a deduction for contributions to a protection against loss account (sec. 824).

[9] See National Association of Insurance Commissioners ("NAIC")-approved annual statement form (often called the yellow blank) used by property and casualty insurance companies for financial reporting. The accounting techniques used in preparing this annual statement are referred to as statutory accounting principles (SAP), and generally are more conservative than generally accepted accounting principles (GAAP) and the cash and accrual methods of tax accounting.

Reasons for Change

Present law permits a deferral of unearned premium income, while the expenses of earning the deferred income (e.g., premium acquisition expenses) may be deducted currently. Several proposals for tax reform in the area of property and casualty insurance have suggested that permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for associated costs of earning the deferred income also produces a mismatching of income and expenses, and a resulting mismeasurement of income.[10] The committee has acted in this bill to provide a better matching of income and expenses by reducing the deduction for unearned premiums in a manner intended to reflect costs of earning the deferred amounts.

Explanation of Provision

Under the bill, a property and casualty insurance company is required to reduce its deduction for unearned premiums by 20 percent. This amount is intended to represent the allocable portion of expenses incurred in generating the unearned premiums. Thus, for taxable years beginning after 1985, only 80 percent of the increase in unearned premiums in each year is deductible. All items which are included in unearned premiums under sec. 832(b) of present law are subject to this reduction in the deduction. To the extent there is a decrease in the unearned premium reserve for a taxable year beginning after 1985, the resulting inclusion in income would be reduced; only 80 percent of the amount would be includible. Thus, if the taxpayer's unearned premium reserve increased in 1986 from $1,000 to $1,100, the net deduction for unearned premiums would be $80. Similarly, if the unearned premium reserve declined in 1987 to $900, the taxpayer would be required to include $160, rather than $200, in income.

The bill also provides for the inclusion in income of 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1986. This income is includible ratably over a 5-year period commencing with the first taxable year beginning after December 31, 1985. In each taxable year during this period, 4 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1986 is included in income. Thus, over the 5 taxable years beginning after 1985, a total of 20 percent (4 percent each year) of a company's pre-1986 unearned premium reserve is required to be included.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 1985. The inclusion in income of 20 percent of

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[10] See General Accounting Office, *Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry* (GAO/GGD-85-10), March 25, 1985 ("GAO Report"); tax reform proposals made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"); the 1984 Treasury Department Report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report").

unearned premium reserves outstanding for the most recent taxable year beginning before January 1, 1986, takes effect ratably (4 percent per year) over the 5 taxable years beginning after December 31, 1985, and before January 1, 1991.

2. Treatment of Certain Dividends and Tax-Exempt Interest (sec. 1022 of the bill and sec. 832(b) of the Code)

Present Law

Property and casualty companies are generally subject to tax on underwriting income (sec. 832(b)(1) and (3)). In calculating underwriting income, losses incurred (as well as expenses incurred) are deducted from premiums earned. The deduction for losses incurred generally reflects losses paid during the year as well as the increase in reserves for losses incurred but not paid.

Property and casualty insurance companies are also subject to tax on investment income, which generally includes interest, dividends and rents (sec. 832(b)(2)). A property and casualty insurer that includes in its investment income interest exempt from tax (sec. 103) may deduct this interest under section 832(c)(7) of present law. Thus, in effect, the section 103 exclusion is available for eligible investment income. In addition, property and casualty companies are allowed the dividends received deduction (sec. 832(c)(12)).

No reduction in the loss reserve deduction is required, under present law, to take account of the fact that deductible additions to reserves may come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies are not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves are funded with tax-exempt income (or with the deductible portion of dividends received). In the case of life insurance companies, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the prorated policyholders' share of tax-exempt interest (sec. 812).[11] This life insurance tax rule is based on the assumption that reserve increases are being funded out of both taxable and tax-exempt income.

Reasons for Change

The committee believes that it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the addition to reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends. Therefore, the bill includes a proration provision.

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[11] Also, the dividends received deduction is reduced by the policyholders' share of the dividends (sec. 805(a)(4)).

Explanation of Provision

Under the bill, the deduction for losses incurred is reduced by a specified portion of the insurer's tax-exempt interest and of the deductible portion of dividends received (with special rules for dividends from affiliates). For this purpose, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. The specified portion for taxable years beginning after December 31, 1985, is 10 percent, increasing to 15 percent for taxable years beginning after December 31, 1987.

In the case of dividends from affiliates, 100 percent of which are deductible under present law,[12] the portion which is subject to proration in the hands of the recipient property and casualty company is that portion which is attributable to tax-exempt interest or nonaffiliate dividends (that is, those dividends which would not be eligible for the 100 percent dividends received deduction. Special rules for dividends from insurance affiliates (whether life or property and casualty) provide that the amount of the reduction in the deduction for losses incurred as a result of proration in the hands of the recipient property and casualty company is offset by the effect of proration as applied to the affiliate. The special rules for proration of dividends from insurance affiliates are similar to rules applicable, under the technical corrections portion of this bill, to the treatment of dividends received by life insurance companies from other life insurance companies.

This provision may be illustrated as follows. Assume that, in 1987, a property and casualty insurer has tax-exempt interest of $1,000 and receives a dividend of $100 that is not eligible for the 100 percent dividends received deduction (i.e., the dividend is 85 percent deductible). In addition, the company receives from an affiliate a dividend of $400 (none of which is attributable to amounts subject to proration) that is eligible for the 100 percent dividends received deduction. Under this provision, the deduction of losses incurred would be reduced by $108.50. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

The proration rule does not apply to tax-exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired before November 15, 1985. The proration rule does apply to such amounts received or accrued on any stock or obligation acquired after November 14, 1985. In the case of dividends from affiliates, special rules apply. The portion of dividends received from an affiliate attributable to stock or obligations (the interest on which is tax-exempt) acquired by the affiliate after November 14, 1985, is subject to the proration rule. Further, if an affiliate is acquired after November 14, 1985 (so that it is thereafter

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[12] Such dividends include any dividend if the percentage used for purposes of determining the deduction allowable under section 243 or 244 is 100 percent, regardless of whether, under the bill, such dividends may be eligible for a dividends received deduction in a different percentage in future taxable years. Under the bill, such dividends also include a dividend received by a foreign corporation from a domestic corporation which would be a 100 percent dividend of section 1504(b)(3) did not apply for purposes of applying section 243(b)(5).

treated as an affiliate), each share of stock or obligation (the interest on which is tax-exempt) held by the affiliate (or by its subsidiaries which are affiliates), whenever acquired by the affiliate, is treated as acquired after November 14, 1985. Thus, the portion of a dividend from any affiliate acquired after November 14, 1985 attributable to amounts subject to proration will be subject to the proration rules. However, dividends not attributable to prorated amounts will not be prorated even if the affiliate payor was acquired after November 14, 1985.

Effective Date

The provision relating to proration of tax-exempt interest and the deductible portion of dividends received (sec. 1022 of the bill) at the rate of 10 percent is effective for taxable years beginning after December 31, 1985. Effective for taxable years beginning after December 31, 1987, the rate is increased to 15 percent. The provision applies only to investments made after November 14, 1985, including distributions with respect to stock acquired after November 14, 1985.

3. Taxable Income of Companies under Part II and III May Not Be Less Than 20/36 of Net Gain From Operations (sec. 1023 of the bill and sec. 846 of the Code)

Present Law

Present law provides generally that property and casualty companies are required to include their underwriting and investment income or loss in taxable income (sec. 832(b)). Underwriting loss, if any, may offset investment income. Among the items that are deductibility in calculating underwriting income are additions to reserves for losses incurred and for unearned premiums. Thus, generally, underwriting income is determined in a manner similar to the manner in which insurers account for underwriting income for statutory accounting purposes. Consequently, the deduction for losses incurred may include the amounts of contested liabilities, and amounts which are estimated (and which therefore may be subject to future change when the amounts can be determined with reasonable accuracy).

This method of tax accounting for losses differs from the rules generally applicable under the cash and accrual methods of accounting. Under the cash method, amounts representing allowable deductions are generally taken into account for the taxable year in which they are paid (Treasury Reg. sec. 1.461-1(a)(1)). Thus, under the cash method of accounting, unpaid losses would not be currently deductible.

Under the normal rules of accrual method tax accounting, the all-events test must be met, and economic performance generally must have occurred, before a deduction may be accrued. The all-events test provides that "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy" (Treasury Reg. sec. 1.461-1(a)(2)). A contested liability may not be deducted unless the taxpayer has transferred

money or other property beyond his control to provide for the satisfaction of the liability (sec. 461(f)). If the liability of the taxpayer requires the taxpayer to provide property, economic performance occurs as the property is provided by the taxpayer. In the case of workers' compensation and tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as the payments are made. Thus, under the accrual method of accounting, contested liabilities and amounts which cannot yet be determined with reasonable accuracy would not be currently deductible, and losses generally would not be deductible until the loss is paid.

Reasons for Change

The committee believes that present law may not accurately measure the income of property and casualty insurers. Unlike other taxpayers, property and casualty insurance companies are permitted to deduct losses prior to the time the loss is paid or accrued. The committee believes that the present-law treatment of property and casualty companies thereby permits such companies to overstate the true current cost of the insured loss; the deduction for such losses is overstated by the amount by which the nominal dollar value of a loss exceeds the present value of the insurance company's liability to pay the resulting claim. The longer the period of time involved, the greater the overstatement. In other words, the failure of current law to reflect the time value of money permits these companies to understate their income.

The committee also recognizes that the nature of the business of a property and casualty company affects the extent to which loss deductions are overstated. For example, some types of policies (such as medical malpractice or commercial liability policies) typically give rise to a long deferral period between occurrence of a loss and payment of a claim. These "long-tailed" losses receive the greatest benefit from the failure to take into account the time value of money. The committee further acknowledges that the tax treatment of loss reserve deductions has contributed to what is referred to as cash flow underwriting, in which a property and casualty company establishes a premium based on the assumption that investment income (which often is tax exempt) will offset underwriting losses.

The committee believes that it is necessary to undertake a comprehensive examination of the tax treatment of the property and casualty insurance industry. In this respect, the committee believes that the starting point in this process would be to consider whether there is justification for treating loss deductions of property and casualty companies more favorably than the treatment of losses and expenses of other taxpayers. If no special treatment is justified, one way to achieve tax treatment equivalent to other taxpayers would be to allow deductions for losses when economic performance occurs. Alternatively, other methods of accounting could be devised that would produce consequences economically equivalent to the economic performance rules (such as the special rules fur nuclear decommissioning expenses contained in sec. 468A). If unique characteristics of the property and casualty insurance in-

dustry justify special tax treatment, one approach would be to consider the pre-tax discounting proposal of the GAO Report.

However, the committee is concerned that there is inadequate time, during consideration of fundamental tax reform, to evaluate properly the various proposals for reforming the taxation of property and casualty insurance companies. Therefore, the committee has adopted interim proposals in order to give the committee time to study more carefully the proposals that have been suggested and to consider whether other approaches are more appropriate.

The committee believes further that, if action is not taken with respect to the taxation of the property and casualty industry in the near future, an alternative method of taxing property and casualty companies should be adopted. Thus, the bill provides that, for taxable yeras beginning after 1987, the taxable income of a property and casualty insurance company must bear a relationship to the income or loss of the company as measured for purposes of the annual statement financial accounting required by property and casualty insurers under State law.

The committee recognizes that the proposal that is scheduled to go into effect in 1988 does not address the basic issues (i.e., the treatment of loss reserve deductions) with respect to the taxation of property and casualty insurers, but the provision is designed to operate as a stopgap measure until Congress has the time to address these issues.

Thus, the bill requires studies to be conducted with respect to aspects of taxation of property and casualty insurance companies, including treatment of loss reserves. After reviewing the results and recommendations of the studies, the committee may make further changes intended to improve the measurement of income under Parts II and III of subchapter L.

Explanation of Provision

For taxable years beginning after December 31, 1987, the taxable income of property and casualty companies must bear a certain relationship to the company's adjusted net gain from operations. The company's taxable income under the provision is the greater of its regular taxable income (which would be taxable at a maximum corporate of 36 percent), or 20/36ths of its adjusted net gain from operations. In effect, the company's tax liability is to be the greater of its regular tax at a maximum 36-percent rate, or the tax on its net gain at a maximum 20-percent rate.

The company's net gain from operations is generally the amount shown on line 18(b) of the annual statement approved by the National Association of Insurance Commissioners. This amount includes the company's underwriting and investment income (including tax-exempt interest and the the deductible portion of dividends received), before Federal and foreign income taxes and after the crediting of policyholder dividends. Under the bill, this amount is adjusted to exclude the amounts of tax-exempt interest and the deductible portion of dividends received attributable to investments made before November 15, 1985. Thus, the adjusted net gain from operations may be a lower amount than that actually reported by the company on line 18(b) of its annual statement.

If the company's regular taxable income (under secs. 821 or 832, without regard to this rule) would be less than 20/36ths of its adjusted net gain from operations, the company is subject to tax on 20/36ths of its adjusted net gain from operations. Similarly, if the company would have a regular tax loss, but has a positive or zero adjusted net gain from operations, it is subject to tax on 20/36ths of its adjusted net gain from operations. In this circumstance, the loss that would otherwise arise under the regular tax (without regard to this provision) is disallowed for all purposes, including as a carryover to other taxable years and for purposes of computing consolidated taxable income of an affiliated group. If the company would have a regular tax loss, but 20/36ths of its adjusted net loss from operations is a smaller amount, then its loss is limited to the smaller amount. In this circumstance, the larger loss which would otherwise arise under the regular tax (without regard to this provision) is disallowed.

To illustrate, if a company's regular taxable loss were of $1,000,000 and its adjusted net gain from operations were $900,000, then the company would be subject to tax on $500,000 (i.e., 20/36ths of its adjusted net gain from operations). Similarly, if this company had an adjusted net loss from operations of $900,000, its loss would be limited to $500,000 (i.e., 20/36ths of $900,000).

In determining regular taxable income for purposes of making the comparison to 20/36ths of adjusted net gain from operations under this provision, the regular taxable income taken into account is that amount determined after the application of carryovers of net operating losses (or net unused losses under sec. 824(b)) arising in taxable years beginning before January 1, 1988, but before the application of such losses arising in taxable years beginning after December 31, 1987. Net operating loss carryovers of property and casualty companies arising in years beginning before January 1, 1988, are not intended to be allowed as a deduction against the adjusted net gain from operations, but net operating losses arising in years beginning on or after that date (which would, therefore, be limited to 20/36ths of adjusted net loss from operations) are allowed against the adjusted net gain from operations.[13] In calculating the tax liability based on adjusted net gain from operations, tax credits (such as the foreign tax credit) are allowed to the same extent as they are against regular tax liability. The corporate minimum tax, if applicable, is separately calculated after the application of this provision.

In applying the provision, the amount of the net gain or loss from operations is adjusted (i.e., reduced) by tax-exempt interest on obligations and the deductible portion of dividends on non-affiliate stock[14] acquired by the taxpayer before November 15, 1985. A special rule applies to dividends received from affiliates. The amount of dividends received from the affiliate (which itself was acquired before November 15, 1985), which is attributable to tax-exempt obligations and non-affiliate stock which the affiliate (or its subsidiaries) acquired after November 14, 1985 is not treated as an adjust-

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[13] It is intended that similar principles be applied to the use of losses on consolidated returns.

[14] This refers to stock other than stock, dividends paid on which are described in note 12 above.

ment (i.e., reduction) to the amount of net gain from operations of the recipient corporation.

In the case of property and casualty companies which file a consolidated annual statement, the determination of each company's adjusted net gain or loss from operations is made on a consolidated basis. Thus, consolidated taxable income calculated with respect only to the property and casualty companies is compared to 20/36ths of consolidated adjusted net gain or loss from operations for those companies, in applying this provision. It is not intended that any portion of an intercompany dividend be eliminated in consolidation, for this purpose, if it has not been included in a subsidiary component member's net gain or loss from operations. In making the adjustment with respect to stock or obligations acquired before November 15, 1985, the rules described in the preceding paragraph apply in these circumstances.

Effective Date

This provision applies to taxable years beginning after December 31, 1987. A transitional rule for any taxable years beginning after December 31, 1987 and before January 1, 1991 provides that the amount of additional tax (if any) imposed by reason of the application of this provision is reduced by 20 percent in those years.

4. Protection against Loss Account (sec. 1024 of the bill and sec. 824 of the Code)

Present Law

Mutual property and casualty insurance companies are permitted a deduction for contributions (which are bookkeeping entries) to a protection against loss ("PAL") account (sec. 824). The amount of the deduction is equal to the sum of 1 percent of the underwriting losses for the year plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. Contributions to the PAL account are taken into income after a 5-year period. The PAL account thus effects a 5-year deferral of a portion of mutual company underwriting income. The intent of Congress in enacting the PAL provision was to provide mutual companies with a source of capital to enable them to compete with stock companies, in the event of a catastrophic loss. While stock companies may enter capital markets and issue new stock to raise money in the event of a catastrophic loss, a mutual company, because it does not issue stock, may not do so. The 5-year partial income deferral provides a source of capital not available to stock companies.

Reasons for Change

The committee believes that the deduction for contributions to the PAL account is not serving its intended purpose and therefore should be repealed. The PAL rules do not actually require that any account actually be maintained to protect against losses; rather, the only protection is afforded in the form of tax savings. The utility of the PAL is greatest where least needed: in the case of mutual companies with current taxable income that can benefit from deferral. Further, the comparison to the ability of stock companies

with catastrophic losses to raise funds in capital markets may not be entirely appropriate, because any company may not readily be able to raise funds when its financial prospects are dimmed by serious losses. Therefore, the committee has taken action to repeal the provision.

Explanation of Provision

Code section 824, allowing a deduction for contributions to a PAL account, is repealed. PAL account balances are includible in income over the first five taxable years beginning after December 31, 1985. The amount includible is the greater of the amount includible for the year had the subtraction provisions of section 824 remained in effect (but no further additions had been made), or an amount equal to a required percentage of the balance remaining in the account at the close of the preceding taxable year. For taxable years beginning in 1986, the required percentage is 20; for 1987, 40; for 1988, 60; for 1989, 80; and for 1990, 100.

Effective Date

The repeal of the deduction for contributions to a PAL account is effective for taxable years beginning after December 31, 1985.

5. Special Exemptions, Rates and Deductions of Small Mutual Companies (sec. 1025 of the bill and secs. 501, 821, 823 and 847 of the Code)

Present Law

Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of the gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt (sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and generally are taxed solely on investment income. This provision does not apply to any mutual company that has a balance in its PAL account, or that, pursuant to a special election, chooses to be taxed on both its underwriting and investment income. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income. Mutual reciprocal underwriters or interinsurers are generally taxed as mutual insurance companies, subject to special rules (sec. 826).

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay tax at a lower rate. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The present law applicable to small and certain ordinary mutual companies is inordinately complex and should be simplified. The committee believes that one provision should afford benefits comparable to present law to small mutual companies, and that it should reflect the benefits which may have been available had the the PAL account deduction not been repealed. Finally, the committee believes it is appropriate to eliminate the distinction between small mutual companies and other small companies, and extends the benefit of the small company provision to all eligible small companies, whether stock or mutual.

Explanation of Provision

The bill provides that mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed $500,000. This provision changes the nature of the ceiling amount for tax exemption from certain gross receipts to direct or net written premiums, and increases the ceiling amount from $150,000 to $500,000.

In addition, the bill repeals the special rates, deductions and exemptions for small mutual companies and substitutes a single provision (sec. 847 of the Code). The new provision allows mutual and stock companies with net written premiums or direct written premiums (whichever is greater) in excess of $500,000 but less than $2,000,000 to elect to be taxed only on taxable investment income. To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1985.

6. Study of Policyholder Dividends of Mutual Companies (sec. 1026 of the bill)

Present Law

Under present law, property and casualty insurance companies are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such (sec. 832(c)(11)). Stock companies may not, however, fully deduct dividends paid to shareholders. Policyholder dividends and shareholder dividends are treated differently for tax purposes at the dis-

tributee level as well as at the company level. Policyholder dividends are generally considered price rebates and are not taxable distributions (unless the insurance premiums were deducted by the policyholder). Dividends paid to shareholders in their capacity as shareholders, on the other hand, constitute ordinary income to the recipient shareholders to the extent of the distributing corporation's earnings and profits. Unlike mutual property and casualty companies, however, mutual life insurance companies must reduce the amount of deductible policyholder dividends by an amount intended to reflect the portion of the distribution allocable to the companies' earnings on equity (as distinguished from the proportion which is a policyholder rebate).

Reasons for Change

The committee recognizes that there may be inequity arising from the difference in tax treatment of dividend distributions of stock property and casualty companies, and policyholder dividends of mutual companies. It may be appropriate, as in the case of life insurance companies, to treat a portion of mutual company policyholder dividends as a distribution of earnings on equity of the company; however, the rule applying this concept in the life insurance area is enormously complex and controversial in application. Therefore, before applying the concept (or another approach, if preferable) to property and casualty insurers, the committee believes it would be preferable to review the results and recommendations of a study to be conducted by the Treasury Department.

Explanation of Provision

The Treasury Department is required to conduct a study of the tax treatment of policyholder dividends by mutual property and casualty insurance companies, and has the authority under the bill to require the furnishing of information necessary to conduct the study. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate and the Joint Committee on Taxation no later than January 1, 1987, so that the committee may take such further action regarding the tax treatment of mutual company policyholder dividends as is appropriate.

7. Study of Loss Reserves (sec. 1027 of the bill)

Present Law

Section 832(b) provides that, in determining underwriting income of a property and casualty insurer, a deduction is allowed for losses incurred. The deduction for losses incurred includes losses paid during the year, and also includes the increase in the reserve for unpaid losses during the year. Unpaid losses may include contested claims and losses which have been incurred but not reported ("IBNR" losses). Generally, the IBNR component[15] of the deduc-

[15] IBNR losses include actual but not contingent losses. See *Maryland Savings-Share Insurance Corp.* v. *U.S.*, 644 F. 2d 16 (Cl. Ct. 1981).

tion for reserves for unpaid losses is estimated. Thus, the deduction for unpaid losses includes the amount of actual and estimated insurance losses that have been incurred, and the deduction is allowed in the year the losses are incurred or are estimated to have been incurred.

Reasons for Change

The committee believes that several aspects of present law have resulted in mismeasurement of income of property and casualty insurance companies. Many of the aspects which lead to mismeasurement of taxable income are based on principles of statutory accounting, which reflect state law reserve requirements, particularly those relating to reserves for losses incurred. State law reserve requirements generally are intended to promote insurance company solvency rather than to provide an accurate measure of economic income for any given year. As a result, these rules do not take account of the difference between the time the reserve for losses incurred is to be established (i.e., the year in which the event covered by insurance occurs) and the time when the items are released from the reserve (i.e., the year in which claims are satisfied or otherwise extinguished). Thus, the amount initially included in the reserve is generally equal to the amount which it is estimated will be paid as a claim in a future year, without any reduction to take account of the income earned on the reserve assets in the intervening period between the year when the insured event occurs and the year when the claim is satisfied.[16]

The committee recognizes that changes to the taxation of property and casualty insurers are appropriate. There has been disagreement, however, as to the nature of the changes which should be made to correct mismeasurement of income attributable to the treatment of loss reserves under present law. Consequently, the committee has requested a study to be performed, and expects to make further changes with respect to the tax treatment of loss reserves of property and casualty insurance companies.

Explanation of Provision

The Treasury Department (in consultation with the Joint Committee on Taxation) is required to conduct a study of the treatment of loss reserves of property and casualty insurance companies. The Treasury has authority under the bill to require the furnishing of information necessary to conduct the study. The results of the study together with recommendations are to be submitted to the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate no later than January 1, 1987, so that the committee may consider the recommendations and take such further action regarding the tax treatment of loss reserves of property and casualty companies as is appropriate.

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[16] In the case of claims for losses incurred, the amount added to the reserve is the company's estimate of the probable amount of the losses which will be paid.

Revenue Effect of Part C

The provisions are estimated to increase fiscal year budget receipts by $356 million in 1986, $743 million in 1987, $980 million in 1988, $1,305 million in 1989, and $1,591 million in 1990.

TITLE XI—PENSIONS AND DEFERRED COMPENSATION; FRINGE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS

A. Limitations on Treatment of Tax-Favored Savings

1. Individual Retirement Arrangements (IRAs) (sec. 1101 of the bill and sec. 219 of the Code)

Present Law

Under present law (Code sec. 219), an individual generally is entitled to deduct from gross income the amount contributed to an individual retirement arrangement (an IRA), within limits. The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment).

Under a spousal IRA, an individual is allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year; (2) the spouse has not attained age 70½; and (3) the couple files a joint income tax return for the year. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return is increased to the lesser of $2,250 or 100 percent of compensation includible in gross income. The annual contribution may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000.

Amounts withdrawn from an IRA prior to age 59½, death, or disability of the owner of the IRA are subject to a 10-percent additional income tax (sec. 408(f)). (See, also, the discussion relating to Treatment of Distributions in Part C, below).

Reasons for Change

The individual retirement savings provisions of the Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan or a governmental plan maintained by their employer. At that time, individuals who were active participants in employer plans were not permitted to make deductible IRA contributions.

The original IRA provisions created uneven effects among taxpayers because the active participant restriction did not measure the amount of benefit that an individual accrued in an employer plan nor the extent to which the individual's benefit was vested. Consequently, the Congress, in the Economic Recovery Tax Act of 1981, eliminated the active participant restriction and extended IRA availability to all taxpayers because of the difficulties of re-

solving these uneven effects and the desire to provide a discretionary retirement savings arrangement that is uniformly available.

Since 1981, many employers have adopted qualified cash or deferred arrangements, which permit employees to make discretionary contributions that are provided with tax-favored treatment essentially equivalent to IRA contributions. However, the limits on elective deferrals under cash or deferred arrangements are much higher than the limits on IRA contributions. In addition, many employees are permitted to make significant elective deferrals to tax-sheltered annuities. The committee believes that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduces the prior concern that individuals in qualified plans should be able to save additional amounts for retirement on a discretionary basis.

Data show that IRA utilization is greatest among upper-income taxpayers. The committee believes that those taxpayers for whom IRA utilization is the largest would generally have saved without regard to the tax incentives. Further, the committee believes it is appropriate to limit the total tax-favored treatment provided to discretionary savings. Thus, the committee concluded that it is necessary to coordinate the limits on deductible IRA contributions with the limits on elective deferrals under a cash or deferred arrangement and with the limits on contributions to tax-sheltered annuities pursuant to a salary reduction agreement.

Further, the committee believes that the manner in which these limits are coordinated is important both to improve the distribution of IRA utilization among all income groups and to strengthen the nondiscrimination requirements for qualified cash or deferred arrangements. Therefore, the committee's bill reduces an individual's IRA deduction limit by the amount of elective contributions to a qualified cash or deferred arrangement or a tax-sheltered annuity.

Finally, the committee recognizes that the current spousal IRA deduction limit creates anomalous results in the case of a spouse whose earned income is less than $250 a year. The committee's bill eliminates this anomaly.

Explanation of Provisions

Coordination of IRA deduction with elective deferrals

Under the coordination rules of the bill, an individual's IRA deduction limit for a taxable year is reduced, dollar for dollar, by the amount of an individual's elective 401(k) or 403(b) deferrals for such year. In the case of an individual claiming a spousal IRA deduction for a taxable year, the amount of the reduction is limited to the first $2,000 of the individual's elective deferrals plus the amount (if any) of the spouse's elective deferrals for the year.

The bill defines elective 401(k) or 403(b) deferrals to mean, with respect to any taxable year, the sum of (1) an individual's elective deferrals under a qualified cash or deferred arrangement (to the extent the deferrals are not currently included in income under section 402(a)(8)), and (2) any contribution to a tax-sheltered annuity made pursuant to a salary reduction agreement (to the extent the contribution is not currently included in income under section

403(b)), whether or not the salary reduction agreement is evidenced by a written agreement or otherwise (see sec. 3121(a)(5)(D)). The amount of elective 401(k) or 403(b) deferrals for any year is determined without regard to any community property laws.

For purposes of the coordination rule, elective 401(k) or 403(b) deferrals are counted against the IRA deduction limit for the taxable year in which the deferrals would have been included in the individual's income absent the deferral.

The following example illustrates the application of the coordination rule. Assume that an individual earning $20,000 during the taxable year makes $1,500 of elective deferrals under a qualified cash or deferred arrangement or a tax-sheltered annuity for the year. The $2,000 IRA deduction limit for such individual for the year is reduced by the full $1,500. Thus, for the taxable year, this individual may make up to $500 in deductible IRA contributions. Alternatively, if the individual is married and the individual and spouse file a joint return and make the spousal IRA election, then up to $750 of deductible IRA contributions are permitted for the taxable year. Of this $750, at least $250 must be allocated to the spouse's IRA. Further, if the spouse has made elective deferrals for the year, the amount of deductible IRA contributions that is permitted is reduced by the amount of the spouse's elective deferrals.

Of course, the usual IRA rules permitting withdrawals of excess contributions apply to IRA contributions that become excess contributions as a result of this coordination. Thus, for example, if an individual made a 1986 IRA contribution of $2,000 on May 1, 1986, before becoming eligible to participate in a cash or deferred arrangement, that $2,000 contribution will not preclude the individual from participating in the cash or deferred arrangement once he became eligible. To avoid IRA excess contribution penalties, however, the IRA contribution (and income thereon) must be withdrawn before the due date for the individual's 1986 tax return (April 15, 1987, or later, if extended).

Spousal IRA deduction

Under the bill, the spousal IRA provision is amended to eliminate the requirement that the spouse have no compensation for the year in order to be eligible for the spousal IRA contribution. Therefore, under the bill, the spousal IRA is available either if (1) the spouse has no compensation for the taxable year or (2) the spouse elects to be treated for the taxable year as having no compensation.

For purposes of this provision, if a spousal IRA deduction is claimed on the couple's tax return for the taxable year, the spouse is deemed to have elected to be treated as having no compensation.

Effective Dates

The provisions generally are effective for taxable years beginning after December 31, 1985. For purposes of the coordination of elective deferrals with IRA contributions, a special effective date is provided in the case of certain elective deferrals under a plan maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers. Under this effective date,

the coordination provision does not apply to elective deferrals made pursuant to a collective bargaining agreement in taxable years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after November 21, 1985, are disregarded in determining the termination date of the collective bargaining agreement.

2. Qualified Cash or Deferred Arrangements (secs. 1102, 1111, and 1112 of the bill and secs. 401(k), 402, and 4979 of the Code)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan (or an eligible pre-ERISA money purchase pension plan) meets certain requirements described below (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Nondiscrimination requirements

The amount that a highly compensated employee can elect to defer, tax free, under a qualified cash or deferred arrangement depends (in part) on the level of elective deferrals by other employees. Special nondiscrimination tests apply a limit on elective deferrals by the group of highly compensated employees. The limit is determined by reference to the level of deferrals by other employees. An employee is considered highly compensated, for this purpose, if the employee is one of the most highly compensated 1/3 of all employees. These nondiscrimination tests provide that the special treatment of elective deferrals is not available unless the cash or deferred arrangement does not disproportionately benefit highly compensated employees.

The nondiscrimination tests are based on the relationship of the actual deferral percentage for the group of highly compensated employees to the actual deferral percentage for the group of other employees. The deferral percentage for an employee for a year is the percentage of that employee's compensation that has been electively deferred for the year. The actual deferral percentage for a group of employees is the sum of the deferral percentages for the employees divided by the number of employees in the group. In the case of an eligible employee who does not make any deferrals under the arrangement during the year, the employee's deferral percentage is zero.

A cash or deferred arrangement meets these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highly compensated employees is not greater than 150 percent of the actual deferral percentage for the other eligible employees, or (2) the actual deferral percentage for the highly compensated employees does not exceed the lesser of (a) the actual deferral percentage for the other eligible employees plus three percentage points or (b) 250 percent of the actual deferral percentage

for the other eligible employees. In calculating these deferral percentages, contributions by the employer that (1) are nonforfeitable when made and (2) satisfy the withdrawal restrictions applicable to elective deferrals, may be taken into account as elective deferrals by employees if they also separately satisfy the general nondiscrimination rules (sec. 401(a)(4)).

The special nondiscrimination tests applicable to cash or deferred arrangements apply in lieu of the usual nondiscrimination rules for qualified plans, which permit employer contributions to social security to be taken into account. These special nondiscrimination rules are not in lieu of the usual coverage rules requiring that a qualified cash or deferred arrangement cover either 70 percent of all employees or a nondiscriminatory classification of employees.

Withdrawal restrictions

Under present law, a participant in a qualified cash or deferred arrangement is not permitted to withdraw elective deferrals (and earnings thereon) prior to death, disability, separation from service, retirement, or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½ or the occurrence of a hardship. Under proposed regulations, an employee would be treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need.[1]

Limit on elective deferrals

Elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on contributions to a defined contribution plan. Thus, under present law, the sum of an employee's elective deferrals and any other annual additions on behalf of the employee generally cannot exceed the lesser of $30,000 or 25 percent of the participant's nondeferred compensation.

Reasons for Change

The committee is concerned that the rules relating to qualified cash or deferred arrangements under present law encourage employers to shift too large a portion of the share of the cost of retirement savings to employees. The committee is also concerned that the present-law nondiscrimination rules permit significant contributions by highly compensated employees without comparable participation by rank-and-file employees.

The committee recognizes that individual retirement savings can play an important role in providing for the retirement income security of employees. The committee also believes that excessive reliance on individual retirement savings (relative to employer-provided retirement savings) can result in inadequate retirement income security for many rank-and-file employees.

In particular, the committee believes that qualified cash or deferred arrangements should be supplementary retirement savings

[1] Prop. reg. sec. 1.401(k)-1(d)(2).

arrangements for employees; such arrangements should not be the primary employer-maintained retirement plan. Therefore, the committee believes that the extent to which employers can shift the burden of retirement saving to employees should be reduced. Moreover, the committee finds it necessary to restrict the extent to which employers can condition the receipt of other benefits on employees' elections to defer under a qualified cash or deferred arrangement.

Further, the committee is concerned that the present-law rules relating to qualified cash or deferred arrangements are inequitable because individuals whose employers maintain qualified cash or deferred arrangements can elect to defer up to $30,000 of compensation per year. On the other hand, an individual whose employer does not maintain a qualified cash or deferred arrangement is limited to a $2,000 IRA contribution. Accordingly, to reduce this inequity, the bill reduces the limits on annual elective deferrals under qualified cash or deferred arrangements and coordinates the limits with corresponding limits for tax-sheltered annuities and IRAs.

Further, the committee emphasizes that, even if there were not a concern about the total amount of tax-favored savings that individuals could annually accumulate, the cap on annual contributions and the coordination of the cap with deductible IRA contributions are necessary to ensure the proper operation of the nondiscrimination rules applicable to qualified cash or deferred arrangements.

Another way of achieving this goal is to limit the number of employers that can maintain cash or deferred arrangements. Thus, the committee believes it is necessary to preclude the availability of qualified cash or deferred arrangements to public employers and tax-exempt employers.

In addition, the committee believes that the present-law nondiscrimination rules for qualified cash or deferred arrangements permit excessive tax-favored benefits for highly compensated employees without ensuring that there is adequate saving by rank-and-file employees. Because the committee believes that a basic reason for extending significant tax incentives to qualified pension plans is the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement, the committee concludes that it is appropriate to revise the nondiscrimination rules for qualified cash or deferred arrangements in order to more closely achieve this goal.

Finally, the committee believes that it is necessary to restrict the availability of hardship withdrawals under a qualified cash or deferred arrangement to ensure that the favorable tax treatment for retirement savings is limited to savings that are, in fact, used to provide retirement income.

Explanation of Provisions

Limit on elective deferrals

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. Whether or not an employee has deferred more than $7,000 a year

is determined without regard to any community property laws. In addition, the $7,000 limit is coordinated with elective deferrals under tax-sheltered annuities and the annual deduction limit for IRA contributions.

Unlike the overall limits on annual additions, which apply separately to amounts accumulated under plans of different employers, this $7,000 cap limits all elective deferrals by an employee. Thus, the $7,000 limit applies to aggregate deferrals made under all cash or deferred arrangements and tax-sheltered annuity programs in which the employee participates. In addition, the $7,000 cap applies on the basis of the employee's taxable year, not the plan's limitation year.

Because this $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals made by the employee under that employer's plan during the limitation year, do not exceed the overall limit (the lesser of 25 percent of compensation or $25,000).

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to any qualified cash or deferred arrangements and tax-sheltered annuities in which the employee participates exceeds $7,000, then the amounts in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the year. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements in which the employee participates and notify the administrator of each plan of the portion of the excess deferrals allocated to it. Further, not later than April 15 after the close of the employee's taxable year, each plan is to distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan. This distribution of excess deferrals may be made notwithstanding any other provision of law.

The committee intends that, to ease the administrative burden on employees and employers and the IRS, the arrangements maintained by any single employer should preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000.

The amount of excess deferrals distributed to an employee (plus the income thereon) are included in the employee's income for the year to which the excess deferrals relate. However, the amounts are treated as if they had not been contributed to the qualified cash or deferred arrangement and, therefore, are not subject to any additional income taxes for early withdrawals and are not taken into account in applying the special nondiscrimination tests to the elective deferrals.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income. In addition, undistributed excess deferrals are treated as elective deferrals subject to the special nondiscrimination test.

The following example illustrates the application of the elective deferral limitation. Assume that, for 1987, employee A defers $5,000 under employer X's qualified cash or deferred arrangement and $3,000 under employer Y's qualified cash or deferred arrangement. For 1987, employee A may exclude from income only $7,000 of the total $8,000 of elective deferrals. The $1,000 excess deferral may be withdrawn from X's plan or Y's plan, or partially from both plans. If A provides adequate documentation of the $1,000 of excess deferrals by March 1, 1988, A can request that $750 (plus income allocable to $750) be distributed from X's plan and that $250 (plus income allocable to $250) be distributed from Y's plan.

If the $1,000 of excess deferrals (plus income allocable to the $1,000) is distributed by April 15, 1988, A is required to include the excess (plus income) in gross income for 1987. The amount distributed would not then be included in income again in 1988. Further, A would not be subject to the 15 percent additional income tax on withdrawals prior to age 59½.

Finally, employers X and Y are not permitted to take the excess deferrals into account when they test their qualified cash or deferred arrangements under the nondiscrimination tests for the year to which the excess relates.

If either of the plans fails to make the requested distribution by April 15, 1988, then the excess deferrals are to remain in the qualified cash or deferred arrangement, subject to the general withdrawal restrictions applicable to such arrangements. In addition, notwithstanding that A included the excess deferrals in income for 1987, A will not be treated as having any basis in the excess deferrals that were not distributed. Thus, the full amount of the excess deferrals not distributed will again be included in income when actually distributed from the arrangement. Further, the undistributed excess deferrals will be taken into account in applying the special nondiscrimination tests to the cash or deferred arrangement.

Nondiscrimination requirements

In general

The bill modifies the special nondiscrimination tests applicable to qualified cash or deferred arrangements by redefining the group of highly compensated employees and by modifying the special percentage tests.

Definition of highly compensated employee

Under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or any of the two preceding years, the employee (1) is a 5-percent owner of the employer (as defined in section 416(i)); (2) earns at least $50,000 in annual compensation from the employer; or (3) is a member of the top-paid group of the employer.

Under the bill, the top-paid group of employees includes all employees who (1) are in the top 10 percent of all employees on the basis of compensation paid during such year, and (2) are paid more than $20,000 during such year. However, an employee is not included in the top-paid group if the employee is paid less than $35,000

and is not in the top five percent of all employees on the basis of compensation paid during such year.

In determining whether an employee is in the top-paid group during any year, employees who may be excluded in applying the percentage test of section 410(b)(1)(A) generally are disregarded. However, regulations may require that certain excluded employees be taken into account in appropriate circumstances.

The bill provides that an employee will not be treated as in the top-paid group or as earning in excess of $50,000 during the current year unless such employee also is among the 100 employees who have earned the highest compensation during such year. Furthermore, the committee intends that, in the case of a controlled group of employers otherwise treated as a single employer, regulations may permit the employer to identify its highly compensated employees for a year without regard to the top-paid group for such year by substituting a lower dollar compensation amount (e.g., $40,000) for the $50,000 annual compensation amount if the employer does not maintain an integrated payroll system for all the members of the controlled group.

The bill provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if (1) a family member benefits under the qualified cash or deferred arrangement, and (2) is a family member of either a 5-percent owner or one of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any employer contribution under the plan on behalf of such family member is aggregated with the amounts paid and contributed on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by pay. Therefore, such family member and employee are treated as a single highly compensated employee in applying the special nondiscrimination tests.

For example, if the spouse of the most highly compensated employee of an employer is also an employee and participates in the employer's qualified cash or deferred arrangement, the elective deferrals made by the spouse and the compensation earned by the spouse are aggregated with the elective deferrals made by, and the compensation earned by, the most highly compensated employee for purposes of applying the special nondiscrimination test to the elective deferrals of the most highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Modification of nondiscrimination tests

In addition, the bill alters the special nondiscrimination tests applicable to qualified cash or deferred arrangements so that the actual deferral percentage under a cash or deferred arrangement by highly compensated employees for a plan year may not exceed either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual

deferral percentage for all eligible nonhighly compensated employees plus two percentage points.

Under the bill, if a highly compensated employee participates in more than one qualified cash or deferred arrangement of an employer, the employee's actual deferral percentage for purposes of testing each arrangement under the special nondiscrimination tests is to be determined by aggregating the employee's elective deferrals under all of the arrangements of the employer.

In addition, the bill authorizes the Secretary of the Treasury to prescribe regulations relating to the extent to which elective deferrals under a cash or deferred arrangement of an employer are, or may be, aggregated with certain other types of contributions (e.g., employer matching contributions, nonelective contributions, and employee contributions) for purposes of applying the special nondiscrimination tests. Further, the bill authorizes regulations limiting the multiple use of the second or alternative part of the special nondiscrimination tests.

If the special nondiscrimination rules are not satisfied for any year, the bill provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. Distribution of the excess contributions may be made notwithstanding any other provision of law and the amount distributed is not subject to the additional income tax on early withdrawals.

Excess contributions

Under the bill, excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the bill provides that the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination tests.

For example, assume that the elective deferrals by the three highly compensated employees—A, B, and C—of employer X as of the close of the 1987 plan year are 10 percent, 8 percent, and 6 percent of compensation, respectively. Assume further that the actual deferral percentage limit on elective deferrals for the highly compensated employees in the qualified cash or deferred arrangement for the 1987 plan year is 7 percent.

The following method is to be utilized to determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed. The elective deferrals by the highly compensated employees with the highest deferral ratios are treated

as excess contributions to the extent that reducing such deferrals is necessary to bring the arrangement into compliance with the special nondiscrimination test. In this example, in order to reduce the actual deferral percentage for the highly compensated employees to 7 percent, it is necessary, first, to reduce the elective deferrals of employee A from 10 percent to 8 percent and, second, to reduce the elective deferrals of employees A and B from 8 percent to 7.5 percent. Thus, elective deferrals in excess of 7.5 percent are to be treated as excess contributions.

Excise tax on excess contributions

Under the bill, a penalty tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed no later than 2½ months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed within the applicable 2½ month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash. For purposes of this rule, the first elective deferrals for the plan year will be treated as the excess contributions. If the excess contributions (plus income) are distributed after the 2½ month period and before the close of the subsequent plan year, such amounts are to be included in the employee's income in the taxable year of distribution (rather than in a prior taxable year). In this case, the employer will be subject to the 10-percent excise tax on excess contributions.

Other restrictions

The bill imposes several additional restrictions on qualified cash or deferred arrangements. First, no withdrawals generally are permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, or bona fide plan termination or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½. However, a cash or deferred arrangement (other than a pre-ERISA money purchase pension plan) may permit hardship withdrawals from elective deferrals (but not income on the elective deferrals). Present law standards relating to what constitutes a hardship continue to apply.

In addition, the bill provides that a qualified cash or deferred arrangement cannot require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan in excess of one year of service.

Under the bill, an employer generally may not condition, either directly or indirectly, contributions and benefits (other than matching contributions in the plan of which that arrangement is a part) upon an employee's elective deferrals. For example, an employer may not require an employee to make contributions under a cash or deferred arrangement as a condition of participating in a de-

fined benefit pension plan. Similarly, elective deferrals under a qualified cash or deferred arrangement may not be used to ensure that another plan, when combined with the cash or deferred arrangement, satisfies the usual coverage or nondiscrimination requirements (secs. 410(b) and 401(a)(4)). In addition, under the bill, a floor offset defined benefit pension plan may not provide for offsets attributable to elective deferrals under a qualified cash or deferred arrangement.

The bill provides that qualified cash or deferred arrangements are not available to employees of tax-exempt organizations or governmental entities. However, this restriction does not apply to a plan maintained by a rural electric cooperative (defined in sec. 457(d)(9)(B)), a national association of such cooperatives, or a plan maintained by the Tennessee Valley Authority.

The bill provides that, in the case of employer contributions (including elective deferrals under a qualified cash or deferred arrangement) that satisfy the immediate vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement, the determination of whether the plan to which the contributions are made is a profit-sharing plan is to be made without regard to whether the employer has current or accumulated profits. This is the case even if the plan does not contain a qualified cash or deferred arrangement.

Effective Dates

The provisions relating to qualified cash or deferred arrangements generally are effective for plan years beginning after December 31, 1985. A special effective date is provided in the case of certain elective deferrals under a qualified cash or deferred arrangement maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers. Under this effective date, the provisions generally do not apply to elective deferrals made pursuant to the agreement in taxable years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after November 21, 1985, are disregarded. However, for purposes of applying the $7,000 cap to employees who participate in a collectively bargained plan and one or more other plans, elective deferrals under the collectively bargained plan will limit the amount the employee is permitted to defer under any other plan (but not under the employee's IRA).

A transition rule is provided for purposes of the changes relating to the definition of highly compensated employees. Under this rule, the inclusion of employees who are in the top-paid group in the definition of highly compensated employees does not apply to any year before the first year to which the provision is effective, unless the employer otherwise elects to apply the rule with respect to elective deferrals under all qualified cash or deferred arrangements of the employer and all other contributions subject to the special nondiscrimination tests added by this bill).

The bill also provides a transition rule for the provision that provides that public employers and tax-exempt employers may not maintain qualified cash or deferred arrangements. Under this rule, the provision does not apply to any cash or deferred arrangement maintained by a State or local government or a tax-exempt employer that (1) was adopted by the employer before November 6, 1985, and (2) with respect to which the Internal Revenue Service received, before November 6, 1985, an application for a determination letter that such arrangement is a qualified cash or deferred arrangement.

The bill contains a special effective date for any qualified cash or deferred arrangement maintained by a State or local government and grandfathered under the preceding transition rule. Under this special effective date rule, the new special nondiscrimination tests (including the new "highly compensated employee" definition) and the new withdrawal restrictions will not apply to elective deferrals under such grandfathered arrangement for years beginning before November 22, 1987. For such years, the elective deferrals remain subject to the present-law nondiscrimination test and withdrawal rules.

The bill provides a special transition rule with respect to the prohibition on the use of elective deferrals under a cash or deferred arrangement as a condition to the receipt of any other benefits (other than employer matching contributions under the same plan). Under this rule, a cash or deferred arrangement will not be treated as violating this prohibition for plan years beginning before January 1, 1991, to the extent that the qualified cash or deferred arrangement is part of a "qualified offset arrangement" with a defined benefit pension plan.

3. Employer Matching Contributions and Employee Contributions (sec. 1112 of the bill and secs. 401 and 4979 of the Code)

Present Law

Under present law, a qualified plan may permit employees to make either after-tax or pre-tax contributions to a qualified plan. Employee contributions to a qualified plan may be voluntary or mandatory. Mandatory employee contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining employer matching contributions).

Present law provides that a qualified plan may not discriminate in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. Generally, this nondiscrimination requirement is satisfied with respect to employee contributions if all participants are entitled to make contributions on the same terms and conditions. In the past, voluntary employee contributions have been permitted if all participants are eligible to make contributions and if no employee is permitted to contribute more than 10 percent of compensation, determined based on aggregate contributions and compensation during the period of participation.

Employer matching contributions are required to satisfy the usual nondiscrimination rules applicable to qualified plans, which prohibit a plan from discriminating in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. A plan is not considered nondiscriminatory if the employer's contributions on behalf of employees are a uniform percentage of compensation. Similarly, a plan is considered nondiscriminatory if the employer's contributions are determined to provide nondiscriminatory retirement benefits. Social security contributions of an employer generally can be taken into account in determining whether contributions constitute a uniform percentage of compensation or nondiscriminatory benefits.

Reasons for Change

The committee is concerned that the rules relating to employer matching contributions and employee contributions under present law encourage employers to shift a greater share of the cost of retirement savings to employees. The committee is also concerned that the present-law nondiscrimination rules permit greater tax-favored contributions by or on behalf of highly compensated employees without comparable participation by rank-and-file employees.

In particular, the committee believes that the present-law nondiscrimination rules for employer matching contributions and employee contributions permit significant tax-favored benefits for highly compensated employees without ensuring that there is comparable saving by rank and file employees. The committee believes that a basic reason for extending significant tax incentives to qualified plans is the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement. Accordingly, the committee concludes that it is appropriate to revise the nondiscrimination rules for employer matching contributions and employee contributions in order to more closely achieve this goal.

Explanation of Provision

Under the bill, special nondiscrimination rules are applied to employer matching contributions and employee contributions under all qualified defined contribution plans. These nondiscrimination tests apply in addition to the usual nondiscrimination rules applicable to qualified plans.

Qualified matching and employee contributions

Under the first test, a defined contribution plan (and the employee contribution portion of a defined benefit pension plan) will not be treated as meeting the special nondiscrimination test with respect to employer matching contributions that are qualified employer matching contributions and with respect to employee contributions (other than deductible employee contributions) for a plan year unless the matching contribution percentage or the employee contribution percentage for highly compensated employees does not exceed the greater of (1) 125 percent of the matching contribution percentage or the employee contribution percentage for all other eligible employees or (2) the lesser of 200 percent of the matching contribution percentage or the employer contribution percentage

for all other eligible employees or such percentage plus 2 percentage points.

Under the bill, a matching contribution is defined as (1) any employer contribution made on behalf of an employee on account of an employee's contribution to a plan and (2) any employer contribution made on behalf of an employee on account of an employee's elective deferrals under a qualified cash or deferred arrangement. In order to be qualified employer matching contributions, the matching contributions are required to be (1) nonforfeitable when made, (2) ineligible for withdrawal prior to attainment of age 59½, death, disability, separation from service, or bona fide plan termination, and (3) no greater than 100 percent of the employee's mandatory contributions.

The matching contribution percentage for a specified group of employees is the average of the ratios (calculated separately for each employee in the group) of the amount of the matching contributions actually allocated to the employee's account for the plan year to the employee's compensation for the plan year. For purposes of this test, if an employee contribution is required as a condition of participation in the plan, any employee who would be considered a participant if the employee made a contribution to the plan is treated as a participant in the plan on whose behalf no matching contributions are made. The employee contribution percentage is calculated in the same manner as the matching contribution percentage.

Nonqualified matching contributions

The bill provides that nonqualified matching contributions (i.e., matching contributions that are not qualified matching contributions) are subject to a special nondiscrimination test under which the matching contribution percentage for highly compensated employees is limited to the greater of (1) 110 percent of the matching contribution percentage for the other eligible employees or (2) the lesser of 150 percent of the matching contribution percentage for other eligible employees or the such percentage plus one percentage point.

Definition of highly compensated employee

Under the bill, the definition of "highly compensated employee" for purposes of the special nondiscrimination tests for employer matching contributions and employee contributions is the same as the definition for testing elective deferrals under a cash or deferred arrangement. Thus, in general, for purposes of the special nondiscrimination tests, an employee generally is treated as highly compensated with respect to a year if, at any time during the year or any of the two preceding years, the employee (1) is a 5-percent owner of the employer (as defined in section 416(i)); (2) earns at least $50,000 in annual compensation from the employer; or (3) is a member of the top-paid group of the employer.

Under the bill, the top-paid group of employees includes all employees who (1) are in the top ten percent of all employees on the basis of compensation paid during such year, and (2) are paid more than $20,000 during such year. However, an employee is not included in the top-paid group if the employee is paid less than $35,000

and is not in the top five percent of all employees on the basis of compensation paid during such year. The various special rules, regulation authority, and transition rule applicable to calculation of the highly compensated employees for testing cash or deferred arrangements apply for purposes of the tests for employer matching contributions and employee contributions. The special rules for the treatment of family members of the top 10 highly compensated employees and 5-percent owners and for highly compensated employees who participate in more than one plan of an employer also apply.

In addition, the bill authorizes the Secretary of the Treasury to prescribe regulations relating to the extent to which employer matching contributions, employee contributions, nonelective contributions, and elective deferrals under a qualified cash or deferred arrangement are, or may be, aggregated for purposes of the special nondiscrimination tests. Further, the bill authorizes regulations limiting the extent to which an employer may make multiple use of the second or alternative portion of the special nondiscrimination tests.

Treatment of excess contributions

If the special nondiscrimination rules are not satisfied for any year, the bill provides that the plan will not be disqualified if the excess contributions (plus income allocable to such excess contributions) are distributed before the close of the following plan year. Distribution of excess contributions may be made notwithstanding any other provision of the law, and the amount distributed is not subject to the additional income tax on early withdrawals.

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of employer matching contributions or employee contributions allocated to the accounts of highly compensated employees over the maximum amount of employer matching contributions (or employee contributions) that could be allocated to the accounts of highly compensated employees without violating the special nondiscrimination requirements. To determine the amount of the excess contributions and the employees to whom the excess contributions are to be distributed, the bill provides that the contributions made by or on behalf of highly compensated employees will be reduced in the order of their contribution percentages beginning with those highly compensated employees with the highest contribution percentages.

The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination tests. The bill also provides a special rule for excess contributions that consist of nonvested employer contributions. Such contributions are to be forfeited, rather than distributed. Any excess contributions that are forfeited must be used to reduce employer contributions, or, if reallocated, must be reallocated to participant other that those highly compensated employees who were determined to have excess contributions.

Excise tax on excess contributions

Under the bill, an excise tax is imposed on the employer (sec. 4979). The tax is equal to 10 percent of the excess contributions under the arrangement for the plan year ending in the taxable year.

However, excess contributions do not include any excess contributions that, together with income allocable to the excess contributions, are distributed (or, if nonvested, forfeited) no later than 2½ months after the close of the plan year in which the excess contributions arose.

Excess matching contributions (plus income) and income on excess employee contributions distributed within the applicable 2½ month period are to be treated as received and earned by the employee in the employee's taxable year to which such excess contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee' mandatory contribution relates; i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first matching and employee contributions are deemed to be excess contributions.

Effective Dates

The provisions relating to employer matching contributions and employee contributions generally are effective for plan years beginning after December 31, 1985.

A special effective date is provided in the case of certain contributions under a qualified plan maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers. Under this effective date, the provisions do not apply to contributions made pursuant to a collective bargaining agreement in taxable years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after November 21, 1985, are disregarded.

In addition, these provisions apply to any plan maintained by a State or local government in existence on November 6, 1985, for plan years beginning after November 21, 1987.

4. Unfunded Deferred Compensation Arrangements of State and Local Governments and Tax-Exempt Employers (sec. 1104 of the bill and sec. 457 of the Code)

Present Law

Under present law, a taxpayer using the cash receipts and disbursements method of accounting generally is not required to include compensation in income until it is actually or constructively received (sec. 451). Under the doctrine of constructive receipt, a taxpayer ordinarily will be deemed to have received income if the taxpayer has a right to receive that income and the exercise of that

right is not subject to substantial restrictions (Treas. reg. sec. 1.451-2(a)).

In applying the doctrine of constructive receipt, a number of courts have held that when a taxpayer enters into an agreement with a payor to receive compensation on a deferred basis, rather than currently, the taxpayer generally will not be in constructive receipt of that compensation so long as the agreement is made before the taxpayer obtains an unqualified and unconditional right to the compensation.[2]

On February 3, 1978, the Internal Revenue Service issued proposed regulations that provide generally that, if payment of an amount of a taxpayer's fixed basic or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, then the deferred amount will be treated as received in the earlier taxable year.[3] These proposed regulations would have applied to plans maintained by taxable employers, State and local governments, and nongovernmental tax-exempt organizations.

In the Revenue Act of 1978, Congress exempted from the scope of the proposed regulations compensation deferred under an unfunded deferred compensation plan maintained by a taxable employer. Under the 1978 Act, the year that deferred compensation is to be included in gross income under certain private deferred compensation plans is determined under the principles set forth in the rulings, regulations, and judicial decisions relating to deferred compensation that were in effect on February 1, 1978.

The 1978 Act also exempted from the scope of the proposed regulation certain unfunded deferrals under an eligible deferred compensation plan of a State or local government (sec. 457). Certain tax-exempt rural electric cooperatives are also eligible for this exemption. There is currently no specific statutory exemption from the regulation for the unfunded deferred compensation arrangements of nongovernmental tax-exempt organizations.

Under an eligible unfunded deferred compensation plan of a State or local government, an employee who elects to defer the receipt of current compensation is taxed on the amounts deferred when they are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500 or (2) 33⅓ percent of compensation (net of the deferral). Amounts deferred under a tax-sheltered annuity are taken into account in calculating whether an employee's deferrals exceed the limits.

In general, amounts deferred under an eligible deferred compensation plan may not be made available to an employee prior to separation from service with the employer. In addition, distributions under the plan are required to commence no later than 60 days after the close of the later of (1) the year in which the employee attains the normal retirement age under the plan or (2) the year in

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[2] *See Goldsmith* v. *United States*, 586 F.2d 810 (Ct.Cl. 1978); *James F. Oates*, 18 T.C. 570 (1952; aff'd, 207 F. 2d 711 (7th Cir. 1953)), acq. (and prior nonacq. withdrawn) 1960-1 C.B. 5; *Howard Veit*, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; cf. *Kay Kimbell*, 41 B.T.A. 940 (1940), acq. and nonacq. 1940-2 C.B. 5, 12; *J.D. Amend*, 13 T.C. 178 (1949), acq. 1950-1 C.B. 1; *James Gould Cozzens*, 19 T.C. 663 (1953); *Howard Veit*, 8 CCH Tax Ct. Mem. 919 (1949). *See*, also, Rev. Rul. 60-31, 1960-1 C.B. 174.

[3] Prop. reg. sec. 1.61-16.

which the employee separates from service. Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Under an eligible deferred compensation plan, distributions must be made primarily for the benefit of participants, rather than beneficiaries. If a participant's benefits commence prior to death, the total amount of payments scheduled to be made to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary. This rule differs from the incidental benefit rule applicable to qualified plans under which the value of benefits payable during a participant's lifetime must be projected to exceed 50 percent of the total value of benefits payable with respect to the participant.

Under an eligible plan, if a participant dies prior to the date the entire amount deferred has been paid out, the entire amount deferred (or the remaining portion thereof, if payment commenced prior to death) must be paid to the participant's beneficiary over a period not exceeding fifteen years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, benefits must be paid over the life the surviving spouse or any shorter period.

Deferrals under any plan, agreement, or arrangement with the State that is not an eligible deferred compensation plan (other than a qualified State judicial plan, a qualified plan, or a tax-sheltered annuity) are includible in an employee's gross income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether constructive receipt has taken place.

Reasons for Change

If adopted, the 1978 proposed regulation would prohibit employees of tax-exempt organizations from participating in nonqualified, unfunded deferred compensation plans as a means of providing tax-deferred retirement income. The committee believes that it is inappropriate to apply constructive receipt principles to employees of nongovernmental tax-exempt entities, thereby precluding their ability to fund deferred compensation arrangements on a salary reduction basis, while permitting salary reduction for certain government employees and employees of taxable entities. The committee also believes it is appropriate to impose limits on the amount of compensation that may be deferred under an arrangement maintained by a nongovernmental tax-exempt employer. In the case of a nongovernmental tax-exempt entity, as in the case of a State and local government, the usual tension between an employee's desire to defer tax on compensation and the employer's desire to obtain a current deduction for compensation paid is not present. Accordingly, the committee has determined that unfunded, nonqualified deferred compensation plans should be available to employees of nongovernmental tax-exempt organizations on the same basis as they are made available to employees of State and local governments.

The committee is concerned that the present-law rules relating to the distribution of benefits under an eligible plan permit de-

ferred compensation under such an arrangement to accumulate on a tax-favored basis for a longer period than is permitted under a qualified plan. Accordingly, the committee believes that more restrictive distribution rules should be imposed on unfunded deferred compensation plans to ensure that tax-favored savings are used primarily for retirement purposes.

Explanation of Provisions

Overview

The bill applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations. In addition, the bill (1) requires that amounts deferred by an employee under a qualified cash or deferred arrangement that is grandfathered under the bill be taken into account in determining whether the employee's deferrals under an eligible deferred compensation plan exceed the limits on deferrals under the eligible plan; (2) modifies the distribution requirements applicable to eligible deferred compensation plans; (3) permits rollovers between eligible deferred compensation plans; and (4) modifies the rule that an employee is taxable on deferrals under an eligible plan when such amounts are made available.

Nongovernmental tax-exempt employers

Under the bill, an employee of a nongovernmental tax-exempt organization is not considered to be in constructive receipt of compensation deferred under an eligible deferred compensation plan maintained by the tax-exempt organization if the plan satisfies the requirements applicable to eligible deferred compensation plans of State and local governments. Under the bill, deferrals under an ineligible deferred compensation plan, agreement, or arrangement (other than a qualified State judicial plan, qualified plan, or tax-sheltered annuity) maintained by a nongovernmental tax-exempt entity are to be included in an employee's gross income when the amounts are not subject to a substantial risk of forfeiture.

Offset for deferrals under qualified cash or deferred arrangement

Under the bill, the limits on the amount that a participant may defer under an eligible deferred compensation plan are reduced, dollar for dollar, by a participant's elective deferrals, under a qualified cash or deferred arrangement (except a qualified cash or deferred arrangement maintained by a rural electric cooperative). Of course, the rule has no application except with respect to those employees of State and local governments that maintain a qualified cash or deferred arrangement that is grandfathered under the bill. In addition, as under present law, all amounts deferred under a tax-sheltered annuity are taken into account in calculating whether an employee's deferrals under an unfunded deferred compensation plan exceed the limits on deferrals under an eligible deferred compensation plan.

Minimum distribution requirements

The bill also modifies the distribution requirements for eligible deferred compensation plans maintained by State and local governments and nongovernmental tax-exempt entities. As modified, distributions commencing prior to the death of a participant under an eligible deferred compensation plan are required to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66-2/3 percent of the total benefits payable with respect to the participant.

If the participant dies prior to the date that the participant's entire interest has been distributed, or if the participant dies prior to commencement of the distribution of benefits, the bill requires that payments to the participant's beneficiary commence within sixty days of the close of the plan year in which the participant's death occurs and that the entire amount deferred be distributed over a period not in excess of 15 years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, payments must be made over the life of the surviving spouse or any shorter period.

Whenever distributions (pre- or post-death) are to be made over a period extending beyond one year, the bill requires that the distribution be made in substantially nonincreasing periodic payments not less frequently than annually.

Constructive receipt

The bill provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump sum payment within 60 days of the election. However, the 60-day rule only applies if the employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

Rollovers

The bill also amends present law to permit the rollover of benefits between eligible deferred compensation plans under certain circumstances. If the entire amount payable to an employee under an eligible deferred compensation plan is distributed to the employee within one taxable year, the employee is not required to include in income any portion of the distribution transferred by the employee to another eligible deferred compensation plan within 60 days of the date of receipt of the distribution. The committee intends that an individual may make only one rollover per year, and that an individual may not, in any event, roll over an amount that is required to be distributed under the minimum distribution requirements applicable to eligible deferred compensation plans.

State judicial plans

The bill exempts from the new requirements for eligible deferred compensation plans any qualified State judicial plan (as defined in section 131(c)(3)(B) of the Revenue Act of 1978, as amended by section 252 of the Tax Equity and Fiscal Responsibility Act of 1982).

Effective Date

The provisions are effective for taxable years beginning after December 31, 1985.

5. Deferred Annuity Contracts (secs. 1135 of the bill and sec. 72(u) of the Code)

Present Law

Under present law, income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A deferred annuity is an annuity contract under which the periodic payments begin, if at all, only after a specified period elapses after purchase of the contract. A deferred annuity has two phases: an accumulation phase and a payout phase. By contrast, an immediate annuity only has a payout phase.

Under present law, deferred annuities are often purchased by individuals in order to save for retirement. In addition, deferred annuities are often purchased by employers in order to fund the employer's obligation to provide nonqualified deferred compensation to its employees. Deferred annuities may also be used to fund benefits provided under qualified pension, profit-sharing, or stock bonus plans.

Present law provides an additional income tax on certain early withdrawals under an annuity contract. Under present law, amounts withdrawn from an annuity contract before the owner of the contract attains age 59½ are subject to a 5-percent additional income tax. This additional tax is not imposed if the withdrawal takes place over a term of at least 60 months or if several other exceptions apply.

Reasons for Change

The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.

Further, the committee believes that tax incentives for savings should not be provided unless the savings generally are held for retirement. The committee notes that other forms of tax-favored savings (e.g., IRAs) are subject to higher additional taxes on early withdrawals. In general, the committee believes that the additional income tax on early withdrawals should be the same for all tax-favored retirement savings arrangements and should be increased so that the additional tax serves, in most cases, to recapture a significant portion of the benefits of deferral of tax on income.

Explanation of Provisions

Under the bill, if any annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year.

In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are employees, the contract will be treated as held by the employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis, to fund nonqualified deferred compensation.

Income on the contract means the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years, over (2) the investment in the contract, i.e., the aggregate amount of premiums paid under the contract minus policyholder dividends or the aggregate amounts received under the contract that have not been included in income. The Secretary is authorized to substitute fair market value for net surrender value in appropriate cases, if necessary to prevent avoidance of the otherwise required income inclusion.

The provision does not apply to any annuity contract that is acquired by the estate of a decedent by reason of the death of the decedent, is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA, or is a qualified funding asset for purposes of a structured settlement agreement (sec. 130).

In addition, the bill extends the additional income tax on early withdrawals from qualified plans and IRAs to deferred annuity contracts. In the case of a withdrawal from a deferred annuity contract prior to the owner's attainment of age 59½, death, or disability, an additional income tax is imposed equal to 15 percent of the amount includible in income. The additional income tax does not

apply in the case of substantially equal periodic payments over the life of the owner or over the lives of the owner and a beneficiary.

In circumstances in which an annuity contract is held by a person other than a natural person, there will be no additional tax imposed on an early withdrawal because there has been no tax benefit attributable to deferral of tax on the income on the contract.

Effective Dates

The provisions of the bill are effective for contributions made or withdrawals occurring after December 31, 1985. An exception to the provision that modifies the additional income tax on early withdrawals is provided for individuals who, as of November 6, 1985, have commenced receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments. The committee intends that this exception will be available if (1) the annuity contract provides for only one form of distribution or (2) the contract provides that, in the absence of an election to the contrary, an individual will be paid benefits according to the automatic form of payment specified in the contract and the individual is, in fact, receiving benefits in that form. Further, the committee intends that, if the exception applies to an individual, the rules of present law apply to the amounts received. Therefore, if benefits paid would be subject to the 5-percent additional income tax under present law, that tax will apply to the benefits paid under the exception.

6. Elective Contributions Under Tax-Sheltered Annuities (sec. 1102 of the bill and sec. 402(g) of the Code)

Present Law

Under present law, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (section 403(b)). Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity (sec. 403(b)(2)).

In addition, an increased exclusion allowance is provided for certain church employees whose adjusted gross income does not exceed $17,000. The special exclusion allowance for such employees is not less than the lesser of $3,000 or the employee's includible compensation for the year.

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans. Because tax-sheltered an-

nuities generally are defined contribution plans, the limit on the annual additions on behalf of an employee generally is the lesser of 25 percent of compensation or $30,000. Certain catch-up elections allow an employer to contribute in excess of the usual percentage limits in certain years.

Under present law, employer contributions to a tax-sheltered annuity are included in the wage base for employment tax purposes if made by reason of a salary reduction agreement, whether evidenced by a written agreement or otherwise (sec. 3121(a)(5)(D)). For this purpose, employment arrangements that, under the facts and circumstances, are determined to be individually negotiated are treated as salary reduction agreements.

Reasons for Change

The committee is concerned that the present-law rules relating to tax-sheltered annuity programs are inequitable because individuals whose employers make contributions to a tax-sheltered annuity on their behalf under a salary reduction agreement may elect to save up to $30,000 a year. On the other hand, an individual who is employed by a tax-exempt organization that does not offer a salary reduction arrangement is limited to a $2,000 IRA contribution. One way of reducing the extent to which this inequity occurs is to reduce the limits on contributions to a tax-sheltered annuity made pursuant to a salary reduction agreement.

Further, the committee believes that, in addition to limiting the amount that can be saved on a salary reduction basis, it is necessary to ensure that employees have equal access to tax-sheltered annuities through salary reduction agreements.

Explanation of Provision

Limit on elective deferrals

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all tax-sheltered annuities in which the employee participates is limited to $7,000. Whether or not an employee has deferred more than $7,000 a year is determined without regard to any community property laws. In addition, the $7,000 limit is coordinated with elective 401(k) deferrals and the annual deduction limit for IRA contributions.

Unlike the overall limits on annual additions, which apply separately to amounts accumulated under plans of different employers, this $7,000 cap limits all elective deferrals by an employee. Thus, the $7,000 limit applies to aggregate deferrals made under all tax-sheltered annuity programs and cash or deferred arrangements in which the employee participates.

Because this $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals made by the employee under that employer's tax-sheltered annuity during the limitation year, do not exceed the exclusion allowance or the overall limits on contributions and benefits.

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to any tax-sheltered annuities and qualified cash or deferred arrangements in which the employee participates exceeds $7,000, then the amount in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the year. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the tax-sheltered annuities in which the employee participates and notify the administrator of each program of the portion of the excess deferrals allocated to it. Further, not later than April 15 after the close of the employee's taxable year, each program is to distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan. This distribution of excess deferrals may be made notwithstanding any other provision of law.

The committee intends that the tax-sheltered annuities maintained by any single employer should preclude an employee from making elective deferrals under the program for any taxable year in excess of $7,000.

The amount of excess deferrals distributed to an employee (plus the income on the excess deferrals) are included in the employee's income for the year to which the excess deferrals relate. However, the amounts are treated as if they had not been contributed to the tax-sheltered annuity program and, therefore, are not subject to any additional income taxes for early withdrawals.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income.

Special catch up election

Finally, the bill provides an exception to the $7,000 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the overall limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service, agency, or a church, convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000;

(2) An aggregate limit of $15,000 applies to the total amount of contributions that, in any year, exceed $7,000; and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

Effective Dates

The provisions generally are effective for years beginning after December 31, 1985. A special effective date is provided in the case of a tax-sheltered annuity program maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers. Under this special rule, the provisions do not apply to contributions made under such an agreement in taxable years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after November 21, 1985, are disregarded.

Revenue Effects of Part A

The provisions are estimated to increase fiscal year budget receipts by $554 million in 1986, $1,023 million in 1987, $1,000 million in 1988, $1,169 million in 1989, and $1,377 million in 1990.

B. Nondiscrimination Requirements

1. Nondiscrimination Requirements for Qualified Plans and Tax-Sheltered Annuities (secs. 1113 and 1116 of the bill and secs. 401, 403, and 410 of the Code)

Present Law

Under present law, a qualified plan is required to cover employees in general rather than merely the employees of an employer who are officers, shareholders, or highly compensated. A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

Percentage test

A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

Classification test

A plan meets the classification test if the Secretary of the Treasury determines that it covers a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees). In making that determination, the Secretary is required to consider all the surrounding facts and circumstances, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated.

Nondiscriminatory benefits

Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The present-law nondiscrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

In applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated employees (as a percentage of their compensation) generally is compared with the rate at which benefits are provided for

other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether qualified plan benefits, as a percentage of nondeferred compensation, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits paid for by the employer may be taken into account. For this purpose, social security benefits mean Old Age, Survivors, and Disability Insurance (OASDI) benefits provided under the social security system. Section 401(l) and Revenue Rulings 71-446[4] and 83-110[5] provide guidance for taking social security contributions into account.

Aggregation rules

In applying the qualification rules (including the coverage and nondiscrimination tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). Similarly, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements (sec. 414(m)).

In addition, for purposes of certain rules applicable to qualified plans and simplified employee pensions (SEPs), an individual (a leased employee) who performs certain services for another person (the recipient) on a substantially full-time basis for at least 12 months is treated as the recipient's employee if the services are performed because of an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). Under a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee pursuant to these employee leasing rules is not treated as such an employee if certain requirements are met with respect to contributions provided for the individual under a qualified money purchase pension plan maintained by the leasing organization (sec. 414(n)(7)). The safe-harbor rule is inapplicable to an individual who is otherwise a common-law employee of the recipient.

Finally, the Secretary of the Treasury has the regulatory authority to develop any such rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing or affiliated service group provisions apply through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Aggregation of plans.—Under present law an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements.[6] However, if several plans are designat-

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[4] 1971-2 C.B. 187.

[5] 1983-2 C.B. 70.

[6] Treas. reg. sec. 1.410(b)-1(d)(3)(ii) prohibits this designation in certain cases involving TRASOPs and, prior to 1984, certain plans subject to section 401(a)(17).

ed as a single plan, the plans, considered as a unit, must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of highly compensated employees.

A plan does not satisfy the nondiscrimination requirements if, by any device, it discriminates either in eligibility requirements, contributions, or benefits in favor of highly compensated employees. Some variations in benefits or other plan options may be permitted provided the plan, as a whole, does not discriminate in favor of highly compensated employees.

Comparability

In determining whether several different plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the different plans provide "comparable" benefits or contributions. Revenue Ruling 81-202 [7] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees.

Excludable employees

In applying the percentage test, certain employees who have not yet completed minimum periods of service (generally one year) [8] and employees who have not yet attained certain minimum ages (generally age 21) may be disregarded if they are excluded pursuant to a plan provision. In addition, in applying the percentage test or the classification test, employees not covered by the plan and included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives [9] and one or more employers are disregarded if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and the employer or employers (sec. 410(b)(3)(A)). Certain nonresident aliens and certain airline employees may be disregarded in applying the coverage tests (sec. 410(b)(3)(B) and (C)).

Tax-sheltered annuities

Under present law, no coverage or nondiscrimination rules prohibit an employer's tax-sheltered annuity program from favoring highly compensated employees.

Reasons for Change

The committee recognizes the importance of ensuring that tax-favored qualified plans provide benefits for low- and middle-income employees who otherwise might not have reasonable retirement savings. The committee questions the effectiveness of the present-

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[7] 1981-2 C.B. 93.

[8] Under a special rule, an employee may be excluded from participation for up to three years provided the employee is, after three years, fully and immediately vested in employer-provided benefits.

[9] An organization is not considered to be an employee representative if more than one-half of its members participating in the plan are employees who are also owners, officers, or executives of the employer.

law coverage tests in achieving this goal. Accordingly, the committee believes that it is appropriate to require the Secretary of the Treasury to conduct a study on the effect of the present-law rules, including recommendations as to appropriate changes. The committee intends to conduct a comprehensive examination of the effects of these present-law rules after the Treasury Department submits its study.

The committee believes that it is not appropriate to exempt tax-sheltered annuity programs from all coverage and nondiscrimination rules. The committee does not believe these programs should be granted significant tax advantages while covering relatively small numbers of employees or provide disproportionately large benefits to the highly compensated employees. Accordingly, the committee concludes it is appropriate to apply tests similar to the present-law coverage and nondiscrimination rules to tax-sheltered annuity programs.

Explanation of Provision

Study of coverage

The bill directs the Secretary of the Treasury to study the effect of the present-law coverage tests. In particular, the Secretary is to determine whether the present-law rules are sufficient to ensure that qualified plans cover a significant and nondiscriminatory group of employees. The Secretary is to report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, as well as the Joint Committee on Taxation, with respect to the study by July 1, 1986.

The committee expects that the report will include specific recommendations of any changes that the Secretary finds to be appropriate or necessary, including recommendations for implementing those changes. To ensure that the Secretary can gather needed information, the bill specifically authorizes the collection of data. The committee expects that employers will cooperate with the Secretary of the Treasury to the fullest extent possible in supplying requested data.

Tax-sheltered annuities

In general

The bill generally applies the coverage and nondiscrimination rules of present law (secs. 410(b) and 401(a)(4)) to tax-sheltered annuity programs (other than those maintained for church employees). Under the bill, the coverage and nondiscrimination rules apply to any tax-sheltered annuity programs to which the sponsoring employer makes contributions. To the extent the program permits elective employee deferrals, a special coverage and nondiscrimination rule applies to those elective deferrals.

Employer contributions

If an employer makes contributions to a tax-sheltered annuity program, the bill requires that the program must satisfy the coverage and nondiscrimination rules of present law (secs. 410(b) and 401(a)(4)).

Nondiscriminatory coverage

These rules require that a tax-sheltered annuity program cover employees in general rather than merely the employer's highly compensated employees. A tax-sheltered annuity program will meet the percentage test if it benefits at least 70 percent of all employees. A tax-sheltered annuity program will meet the classification test if the Secretary of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders, or highly compensated. As under present law, the Secretary is required to consider all the surrounding facts and circumstances. Unlike in the pension area, the committee intends that the Secretary will take into account the special circumstances faced by educational organizations and tax-exempt organizations (including the compressed salary scales of those organizations and the special needs of certain educational institutions in attracting visiting professors) in applying the rules.

Under the bill, the present-law rules requiring nondiscriminatory benefits (sec. 401(a)(4)) also are extended to tax-sheltered annuities. Thus, tax-sheltered annuity programs (other than those maintained for church employees) are to provide contributions or benefits that do not discriminate in favor of highly compensated employees.

A tax-sheltered annuity program will satisfy this nondiscrimination test if either the benefits or contributions provided under the program to highly compensated employees (expressed as a percentage of compensation) do not exceed the benefits or contributions provided to other employees. As under the present-law rules applicable to qualified plans, certain employer-provided social security benefits may be taken into account in determining whether contributions or benefits, as a percentage of compensation, discriminate in favor of employees who are highly compensated. Section 401(l) and Revenue Rulings 71-446[10] and 83-110[11] provide guidance for taking social security contributions into account. Of course, as under present law, social security contributions may not be taken into account more than once.

Permissive aggregation

If the tax-sheltered annuity program, standing alone, fails to satisfy these coverage and nondiscrimination requirements, the employer may elect to treat the tax-sheltered annuity program and a qualified plan that it also maintains for employees of the entity sponsoring the tax-sheltered annuity program as a single plan solely for purposes of demonstrating that the tax-sheltered annuity program satisfies the coverage and nondiscrimination requirements.

As under the present-law rules applicable to qualified plans, the tax-sheltered annuity program and the qualified plan, considered as a unit, must provide contributions or benefits that do not discriminate in favor of employees who are highly compensated employees.

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[10] 1971-2 C.B. 187.
[11] 1983-2 C.B. 70.

In general, then, a tax-sheltered annuity program that does not separately satisfy the coverage and nondiscrimination requirements may be aggregated with a qualified plan only if the program and the plan provide comparable benefits. Revenue Ruling 81-202[12] provides guidance (including methods for taking employer-provided social security benefits into account) that may be applied to determine whether the amount of employer-derived benefits or contributions under several plans discriminate in favor of highly compensated employees. Of course, some variations in benefits or other plan options between the tax-sheltered annuity program and the qualified plan may be permitted if the program and the plan, as a whole, do not discriminate in favor of highly compensated employees. In determining whether a tax-sheltered annuity program provides comparable benefits, the committee intends that the Secretary consider the special circumstances faced by educational and tax-exempt organizations. For example, the committee believes that if the annuity program or plan has not been amended to increase benefits, it may be unnecessary to test comparability every year.

However, the committee does not intend that a sponsoring organization is to be able to treat a tax-sheltered annuity program and a qualified plan as a single plan for purposes of determining whether the qualified plan satisfies the applicable coverage and nondiscrimination requirements.

Excludable employees

As under present law, in applying the percentage test, certain employees who have not yet completed minimum periods of service (generally one year)[13] and employees who have not yet attained certain minimum ages (generally, age 21) may be disregarded if they are excluded pursuant to a plan provision. In addition, in applying both the percentage and the classification tests, employees not covered by the plan and included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers are disregarded if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and the employer or employers (sec. 410(b)(3)(A)). Certain nonresident aliens and certain airline employees must be disregarded in applying the coverage tests (sec. 410(b)(3)(B) and (C)).

Elective deferrals

The bill provides a special coverage and nondiscrimination rule applicable to tax-sheltered annuity programs that permit elective deferrals. If the employer makes nonelective contributions under a program, the special rule applies only to the elective deferrals and the general nondiscrimination rules described above apply to the nonelective contributions. If, however, the employer maintains a tax-sheltered annuity program that permits only elective deferrals

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[12] 1981-2 C.B. 93.

[13] Under a special rule, an employee may be excluded from participation for up to three years provided the employee is, after three years, fully and immediately vested.

(i.e., no nonelective contributions are made), only the special rule for elective deferrals applies.

Under the bill, a tax-sheltered annuity program that permits elective deferrals will be considered discriminatory with respect to those deferrals unless the opportunity to make elective deferrals is made available to all employees of the entity sponsoring the tax-sheltered annuity program. To ensure that the opportunity to make elective deferrals is available to all employees, the bill provides that the employer generally is not to require any minimum dollar amount (or percentage of compensation) as a condition of participation. However, because the contribution must be sufficient to make purchase of the annuity contract practicable, the bill authorizes the Secretary of the Treasury to issue regulations permitting an employer to establish a reasonable de minimis threshold. For example, the committee intends that a requirement of minimum annual contributions of $300 (or one percent of compensation) or a minimum monthly contribution of $25 would not be considered discriminatory.

Under the bill, elective deferrals under a tax-sheltered annuity program consist of those employer contributions made by reason of a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. In applying the special test for deferrals, no employees of the entity sponsoring the tax-sheltered annuity program (other than nonresident aliens with no U.S.-source earned income) may be excluded from consideration. For example, the qualified plan rules permitting the exclusion of certain employees based upon age and service and coverage under collective bargaining agreements do not apply.

As under present law, the new coverage and nondiscrimination rules generally apply with respect to the "employer" as defined in section 414(b),(c),(m), and (o). In addition, the present-law rules relating to leased employees continue to apply (sec. 414(n)). However, the rules relating to elective deferrals will apply, pursuant to Treasury regulations, with respect to the entity of the employer sponsoring the tax-sheltered annuity program. For example, in determining whether a tax-sheltered annuity program offered by a State university permits all employees the opportunity to make elective deferrals, the relevant workforce includes all employees of the State university, not all employees of the State.

Employers subject to the nondiscrimination rule

In general, all employers eligible to sponsor a tax-sheltered annuity program are subject to the nondiscrimination rules added by the bill. However, these rules do not apply to tax-sheltered annuity programs maintained for church employees.

For purposes of this exclusion, the term "church" is defined to include only a church described in section 501(c)(3) or a qualified church-controlled organization. These terms generally have the same meaning as they do for purposes of exclusion from the SECA and FICA taxes (sec. 1402 and 3121). Accordingly, for purposes of this provision, the term church includes (1) a convention or association of churches, and (2) an elementary or secondary school that is

controlled, operated, or principally supported by a church or by a convention or association of churches.

Similarly, the term qualified church-controlled organization means any church-controlled tax-exempt organization described in section 501(c)(3) other than an organization that both (1) offers goods, services, or facilities for sale (other than on an incidental basis) to the general public (e.g., to individuals who are not members of the church), other than goods, services, or facilities that are sold at a nominal charge which is substantially less than the cost of providing such goods, services, or facilities, and also (2) normally receives more than 25 percent of its support from either (a) governmental sources, or (b) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses, or from (a) and (b) combined.

A tax-sheltered annuity program of an otherwise qualified church organization will be subject to the coverage and nondiscrimination rules only if both conditions (1) and (2) in the preceding paragraph exist. Thus, these rules generally will not apply to the typical seminary, religious retreat center, or burial society, regardless of its funding sources, because it does not offer goods, services, or facilities for sale to the general public. Similarly, the rules do not apply to a church-run orphanage or old-age home, even if it is open to the general public, if not more than 25 percent of its support was derived from the receipts of admissions, sales of merchandise, performance of services, or furnishing of facilities (in other than unrelated trades or businesses) or from governmental sources. The committee specifically intends that the coverage and nondiscrimination rules will apply to church-run universities (other than religious seminaries) and hospitals if both conditions (1) and (2) exist.

Auxiliary organizations of a church (including youth groups, women's auxiliaries, etc.) generally would satisfy neither of the conditions, and thus the coverage and nondiscrimination rules will not apply. Similarly, these rules generally will not apply to tax-sheltered annuity programs maintained by church pension boards or fund-raising organizations.

Effective Date

These nondiscrimination rules generally apply for years beginning after December 31, 1985. However, with respect to tax-sheltered annuity programs maintained by State and local governments, these nondiscrimination rules generally apply for plan years beginning after November 21, 1987.

2. Social Security Benefits Earned With Prior Employer Not Taken Into Account in Determining Whether Plan is Discriminatory (sec. 1114 of the bill and sec. 401 of the Code)

Present Law

In general

Under present law, a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees) (sec. 410(b)). Under these standards, tests are applied to determine whether the classification of employees who participate in a plan is discriminatory. Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)).

The present-law discrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees.

Generally, in applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated employees (as a percentage of their compensation) is compared with the rate at which the plan provides benefits for other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether qualified plan benefits, as a percentage of compensation, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability insurance (OASDI) benefits provided under the social security system. Section 401(l) and Revenue rulings 71-446[14] and 83-110[15] provide guidance for calculating the maximum amount of social security benefits that may be taken into account under an employer's qualified plan.

Under these rules, a defined benefit pension plan may be "integrated" with OASDI benefits under one of two distinct methods. The first method is "excess plan integration." An excess plan provides benefits based solely upon an employee's compensation in excess of the "integration level." For example, for a "flat-benefit excess plan" the rate of benefits provided above the integration level may not exceed 37½ percent of such compensation with this percentage reduced on account of integrated ancillary benefits. The

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[14] 1971-2 C.B. 187.
[15] 1983-2 C.B. 70.

37½ percent rate is based upon the assumption that the OASDI benefits attributable to employer-contributions under FICA are equivalent to a flat benefit of 37½ percent of compensation up to the integration level. Thus, the plan benefits together with imputed employer-provided OASDI benefits provide total benefits of a nondiscriminatory percentage of compensation.

The second method of integrating a defined benefit pension plan with OASDI benefits is the "offset plan" method. Under this method, the employer-provided portion of Old-Age benefits is subtracted from the otherwise payable pension benefit. For example, a defined benefit pension plan might provide a benefit at age 65 of 50 percent of an employee's compensation less 83⅓ percent (reduced for integrated ancillary benefits) of the Old-Age benefit (reduced for integrated ancillary benefits) payable to such employee under the Social Security Act. The 83⅓ percent again represents the total OASDI benefits assumed to be attributable to employer contributions under FICA expressed as a percentage of the Old-Age benefit payable to the employee.

Under both methods of integrating a defined benefit pension plan, the formula may be a flat-benefit formula as illustrated above or a unit benefit formula under which the benefit is based upon the number of years of service with the employer. An example of a unit benefit formula would be a benefit at age 65 of one percent of average compensation in excess of the integration level for each year of service with the one percent reduced for integrated ancillary benefits.

Under present law, the integration rules allow an employer to implicitly take credit for the OASDI contributions of former employers of an employee. Thus, for example, an employee who retires at age 65 with 15 years of service may receive a benefit under an integrated plan of 37½ of compensation in excess of "covered compensation" (as defined by the integration rules) even though the employee has worked with the employer only for the last 15 years. In contrast, if the same employee retired earlier than age 65, the integration rules would require that the 37½ percent be prorated based on the ratio of the number of actual years of service with the employer to the number of years of service the employee would have had at age 65. The current integration rules are even more generous under an offset plan because the maximum offset of 83⅓ percent (adjusted for ancillary benefits as required) could be applied to an employee retiring at age 65 with as little as one year of service. OASDI benefits are earned, however, over the entire working career of the employee.

Reasons for Change

The committee believes that it is appropriate to preclude any employer from reducing an employee's plan benefits by taking into account social security benefits earned with prior employers.

Explanation of Provision

The bill revises the manner in which a pension plan may be integrated with social security. Pursuant to regulations to be issued by the Secretary of the Treasury, the maximum amount of social secu-

rity benefits that may be taken into account by an employer for any year of service with such employer may not exceed 1/40 of the total social security benefits permitted to be taken into account. Thus, the bill precludes an employer from taking into account benefits attributable to OASDI contributions of former employers of an employee.

The effect of this change upon plans depends upon the method of integrating the defined benefit plan. Under a flat-benefit excess plan, the full 37½ percent excess amount (reduced for integrated ancillary benefits) could be applied only to an employee who had 40 years of service with the employer upon retirement at age 65. If an employee only had 20 years of service with the employer, the maximum excess benefit at age 65 would be 16.75 percent (37½ multiplied by 20/40, the ratio of 20 years of service to 40), assuming that the plan has no integrated ancillary benefits.

For an offset plan the full 83⅓ percent offset (reduced for integrated ancillary benefits) could be applied only to an employee who retired at age 65 with 40 years of service with the employer. Thus, if an employee retired at age 65 with 30 years of service with the employer, the maximum offset would be 62.5 percent (83⅓ multiplied by 30/40, the ratio of 30 years of service to 40), assuming the plan has no integrated ancillary benefits.

The bill generally would not have any affect on unit benefit plans because of the nature of such plans. Thus, for example, a unit benefit plan that provided a benefit of one percent of compensation multiplied by the number of years of service not in excess of 40 offset by 1¼ percent of the employee's old-age benefit multiplied by the number of years of service not in excess of 40 would not be affected by this change. Furthermore, the bill generally would not affect the integration of defined contribution plans integrated with OASDI benefits (except to the extent such plans are determined to be nondiscriminatory on the basis of benefits). Also, the committee anticipates that similar rules would apply to the integration of other employer-provided benefits under Federal, State, or foreign law.

Effective Date

The provision applies to plan years beginning after December 31, 1986.

3. Benefits Treated as Accruing Ratably for Purposes of Determining Whether Plan is Top Heavy (sec. 1115 of the bill and sec. 416 of the Code)

Present Law

In general

For years beginning after December 31, 1983, present law provides additional qualification requirements for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account, (2) provide greater portability of benefits for plan participants by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits.

Top-heavy plan calculation

A defined benefit pension plan generally is top heavy for a year if, as of the determination date for such year, the present value of the cumulative accrued benefits for participants who are key employees exceeds sixty percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a year if, as of the determination date for such year, the sum of the account balances of participants who are key employees exceeds sixty percent of the sum of the account balances of all employees under the plan (sec. 416(g)).

Accrued benefits

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue benefits at a rate that meets one of three alternative schedules (sec. 411(b)). The purpose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under the first alternative, known as the "three-percent rule," a plan participant must accrue a benefit during each year of participation (up to 33⅓ years) not less than three percent of the benefit to which an employee who entered the plan at the earliest entry age and participated until the earlier of normal retirement age or age 65 would otherwise be entitled.

Under the second alternative, known as the "133⅓-percent rule," a plan will satisfy the accrued benefit requirements if the accrued benefit of a plan participant, as of his normal retirement age, is equal to the normal retirement benefit under the plan and the annual rate at which any individual who is or could be a plan participant accruing the retirement benefits in any year, is never

more than 133⅓ percent of the annual accrual rate for any prior year.

Under the third alternative, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the plan's benefit formula if the participant continued to earn annually until normal retirement age the same rate of compensation. The fractional portion is determined by dividing the participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

In determining whether a plan is top-heavy, cumulative accrued benefits are calculated using the benefit accrual method selected by the plan. If the plan is determined to be top-heavy, the plan generally must provide that each participant's minimum benefit is, on a cumulative basis, at least equal to two percent of compensation for each year of service during which the plan is top heavy, not to exceed 20 percent (sec. 416(c)). Under the top-heavy rules, benefits accrued under the plan's benefit formula must be at least equal to the required minimum benefit.

Reasons for Change

The committee is concerned that some employers are trying to avoid application of the top-heavy plan rules by artificially accelerating benefit accruals for non-key employees. If the acceleration is sufficient to ensure that the plan does not provide more than 60 percent of the benefits for key employees, the top-heavy rules (including the top-heavy minimum benefit and vesting rules) will not apply. As a result, the non-key employees often forfeit the benefits. The committee believes it is appropriate to measure accrued benefits on a uniform basis to protect the benefits of rank-and-file employees.

Explanation of Provision

Under the bill, a uniform accrual rule is used in testing whether a qualified plan is top heavy (or super top heavy) (sec. 416(g)(4)(F)). Thus, solely for determining whether the present value of cumulative accrued benefits for key employees exceeds 60 percent of the present value of cumulative accrued benefits for all employees (90 percent for purposes of the super top-heavy plan rules), cumulative accrued benefits would be uniformly measured by applying the fractional rule. Thus, benefits will be treated as accruing no more rapidly than required under the fractional rule.

This rule applies only for purposes of determining whether the plan is top heavy or super top heavy. The rule does not require that the plan actually use the fractional rule for purposes of accruing benefits under the plan.

Effective Date

The provision applies for plan years beginning after December 31, 1985.

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4. Modification of Rules for Benefit Forfeitures (sec. 1116 of the bill and sec. 401 of the Code)

Present Law

Under present law, ERISA and the Code generally require that (1) a participant's benefits be fully vested upon attainment of the normal retirement age specified in the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

When a participant separates from service, nonvested benefits may be forfeited. In a defined benefit pension plan forfeitures may not be used to increase promised benefits because benefits must be definitely determinable; instead, forfeitures must be used to reduce future employer contributions or to offset plan administrative expenses.

The treatment of forfeitures in a defined contribution plan depends on whether or not the plan is a money purchase pension plan. In a defined contribution plan that is not a money purchase plan (e.g., a profit-sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. These reallocated forfeitures increase the benefits of the remaining participants. Alternatively, forfeitures can be used to reduce future employer contributions.

A money purchase pension plan, like a defined benefit plan, is subject to the requirement that benefits be definitely determinable. Accordingly, a money purchase plan must contain a definite contribution formula. Present law also provides that forfeitures may not be used to increase benefits, but must be applied to reduce future employer contributions or administrative costs (sec. 401(a)(8)).

Reasons for Change

The committee believes it is appropriate to provide uniform rules for the treatment of forfeitures under all types of defined contribution plans.

Explanation of Provision

The bill creates uniform rules for forfeitures under any defined contribution plan. The bill permits, but does not require, forfeitures to be reallocated to other participants. Thus, forfeitures arising in any defined contribution plan (including a money purchase

pension plan) can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs.

Effective Date

The provision is effective for years beginning after December 31, 1985.

Revenue Effect of Part B

The provisions are estimated to increase fiscal year budget receipts by a negligible amount.

C. Treatment of Distributions

1. Uniform Minimum Distribution Rules (sec. 1121 of the bill and secs. 401, 403, 408 and new sec. 4974 of the Code)

Present Law

Before-death distribution rules

Under present law, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present law may be satisfied if the participant's entire interest is to be distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and a designated beneficiary.

A participant's required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the participant attains age 70½ or (2) the participant retires, whichever is later. If a participant is a 5-percent owner (sec. 416(i)) with respect to the plan year ending in the calendar year in which the participant attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the participant attains age 70½ even though the participant has not retired.

In addition, the distribution of benefits under a qualified plan must satisfy the incidental benefits rule.[16] Under the incidental benefits rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. However, a distribution pattern is not prohibited by the incidental benefits rule to the extent that it is required by the rules relating to qualified joint and survivor annuities (sec. 401(a)(11)).

After-death distribution rules

Present law provides a minimum distribution requirement with respect to benefits payable from a qualified plan with respect to a

[16] *See e.g.*, Rev. Rul. 72-241, 1972-1 C.B. 108.

participant who has died. The applicable rules depend upon whether benefits commenced before or after the participant's death.

If the distribution of benefits commenced to the participant before death, the remaining portion of the participant's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. Where benefits did not commence prior to the death of the participant, present law requires that the entire interest of the participant be distributed within 5 years after the date of death unless the after-death distribution method meets certain requirements. Under present law, the 5-year distribution requirement does not apply to the portion of a participant's after-death remaining interest payable to a designated beneficiary over the life of the designated beneficiary (or over a period (including a term certain) not extending beyond the life expectancy of the beneficiary) if (1) those distributions commence no later than 1 year after the date of death, and (2) the distributions are paid to the designated beneficiary under rules that meet the minimum distribution requirements for before-death distributions. A second exception to the 5-year distribution requirement applies if the designated beneficiary is the surviving spouse of the participant.

Tax-sheltered annuities and custodial accounts

Present law provides after-death minimum distribution rules similar to the rules for qualified plans (sec. 72(s)).[17]

IRAs

Present law provides before -and after-death minimum distribution rules for IRAs corresponding to the rules applicable to qualified plans. Distributions from an IRA, however, are required to commence no later than April 1 of the calendar year following the calendar year in which the owner of the IRA attains age 70½.

Reasons for Change

The committee is aware that the current absence of uniformity in the distribution rules applicable to tax-favored plans creates significant disparities in opportunities for tax deferral among individuals covered by different types of plans. Uniform rules would eliminate such disparities and would reduce the complexity of the existing rules.

In particular, for most employees, present law uses separation from service after age 70½ as the date benefit distributions from a qualified plan must commence. However, for 5-percent owners and all IRA owners, distributions are required to commence at age 70½ without regard to separation from service. Thus, the rules allow longer deferrals for participants who are not 5-percent owners. Further, the time of separation from service is sometimes difficult to determine, as in the case of employees who cease their regular duties, but continue to work in connection with consulting agreements in order to postpone commencement of benefit payments. The committee believes that the provision of a uniform benefit

[17] The technical corrections provisions of the bill make it clear that both the before- and after-death distribution rules applicable to qualified plans (sec. 401(a)(9)) also apply to tax-sheltered annuities.

commencement date for all tax-favored pension and deferred compensation arrangements would eliminate the current law disparities among various types of retirement vehicles, and would ease administrative burdens in the private and public sectors by eliminating the need for a subjective test to determine when withdrawals are required to begin.

In addition, the application of uniform minimum distribution rules with respect to the permissible periods over which benefits from any tax-favored retirement arrangement may be distributed would ensure that such plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

The committee believes that uniform sanctions should also apply to violations of the minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical distribution requirements with respect to any one participant. Disqualification may result in adverse tax consequences to all plan participants, even though the plan administrator generally is outside the control of the participants, and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the IRS. Although the committee believes that a plan should, by its terms, prohibit the violation of the minimum distribution rules, the committee also believes an operational error should not cause plan disqualification.

Explanation of Provisions

Overview

The bill establishes a uniform commencement date for benefits under all qualified plans, IRAs, tax-sheltered annuities, and custodial accounts. In addition, the bill establishes a new sanction in the form of an excise tax, as an alternative to plan disqualification, for failure to satisfy the minimum distribution rules.

Uniform commencement date

Under the bill, distributions under all qualified defined benefit and defined contribution plans, individual retirement accounts and annuities, and tax-sheltered custodial accounts and annuities must commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70½, without regard to the actual date of retirement.

Excise tax on failure to make a minimum required distribution

Under the bill, the sanction for failure to make a minimum required distribution to a particular participant under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount that should have been distributed (the "minimum required distribution") over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, as under present law, a plan will not satisfy the qualification requirements unless it ex-

pressly provides that, in all events, the distribution under the plan must satisfy the minimum distribution requirements and the incidental benefit rule.

Under the bill, the Secretary of the Treasury is authorized to waive the tax for a given taxable year if the taxpayer to whom the tax would otherwise apply is able to establish that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.

The minimum required distribution in any given taxable year is to be determined under regulations to be issued by the Treasury. The committee intends that where a participant selects a permissible distribution option, the minimum required distribution in any given year is to be the amount required to be distributed in that year under the payout option selected.

If the participant selects an impermissible payout option, the committee intends that the minimum required distribution in any year be the amount that would have been distributable to the participant in that year had the participant selected a joint and survivor annuity payable over the life expectancies of the participant and the beneficiary (if any) actually designated by the participant, taking into account their actual ages. The survivor benefit is assumed to be the maximum percentage of the annuity payable during the participant's lifetime that will not violate the incidental benefit rule. It is intended that the excise tax apply even if the distribution is described in the plan and the plan receives a favorable determination letter.

Effective Dates

The provisions generally apply to distributions made after December 31, 1985. However, for purposes of the required beginning date for commencement of benefits, employees who are not 5-percent owners and who have attained age 70½ by January 1, 1988, may defer the commencement of benefit payments until retirement.

In addition, an employee is not subject to the 50-percent excise tax for failure to satisfy the minimum distribution requirements merely because distributions are made to the employee in accordance with a designation made before January 1, 1984, by the employee in accordance with sec. 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

2. Uniform Additional Income Tax For Early Distributions From Qualified Retirement Plans (secs. 1111 and 1123 of the bill and secs. 72, 401, and 403 of the Code)

Present Law

Withdrawal restrictions

Under present law, benefits may be distributed to a participant in a qualified pension plan only on account of plan termination or the employee's separation from service, disability, or death. In-serv-

ice withdrawals are not permitted under a qualified pension plan before normal retirement age.

Withdrawals under qualified profit-sharing or stock bonus plans are subject to fewer restrictions than those under qualified pension plans. Qualified profit-sharing or stock bonus plans generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship).

Special restrictions apply to benefits under a qualified cash or deferred arrangement. Under present law, a qualified cash or deferred arrangement, by its terms, may not permit a participant to withdraw elective deferrals (or earnings on such deferrals) before the participant dies, becomes disabled, separates from service, or (except in the case of a pre-ERISA money purchase pension plan) attains age 59½ or encounters hardship. Under proposed regulations, an employee is treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need. Present law does not permit distributions under a qualified cash or deferred arrangement on account of plan termination.

Under present law, withdrawals under a tax-sheltered annuity program invested in a custodial account of a regulated investment company (i.e., a mutual fund) may not be made prior to the time the account owner attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship (sec. 403(b)(7)). In contrast, amounts invested in tax-sheltered annuities are not subject to any withdrawal restrictions.

Additional income tax on early withdrawals

Generally, under present law, a 10-percent additional income tax is imposed on withdrawals from an IRA before the owner of the IRA attains age 59½, dies, or becomes disabled. The tax also applies to any withdrawals from qualified plans by or on behalf of 5-percent owners who have not yet attained age 59½, died, or become disabled.

Reasons for Change

Present law imposes withdrawal sanctions with respect to certain tax-favored retirement arrangements and requires withdrawal restrictions to be provided under others. The absence of withdrawal restrictions in the case of some tax-favored arrangements allows participants in those arrangements to treat them as general savings accounts with favorable tax features rather than as retirement savings arrangements. Moreover, taxpayers who do not have access to such arrangements, in effect, subsidize the general purpose savings of those whose employers maintain plans with liberal withdrawal provisions.

Although the committee recognizes the importance of encouraging taxpayers to save for retirement in order to take pressure off the social security system, the committee believes that tax incentives for retirement savings are inappropriate unless the savings generally are not diverted to nonretirement uses. One way to pre-

vent such diversion is to impose an additional income tax on early withdrawals from tax-favored retirement savings arrangements in order to discourage withdrawals and to recapture a measure of the tax benefits that have been provided. Accordingly, the committee believes it appropriate to apply an early withdrawal tax to all tax-favored retirement arrangements. For the same reasons, the committee believes it is appropriate to extend the withdrawal restrictions applicable to tax-sheltered custodial accounts to tax-sheltered annuities generally, and to limit the extent to which participants may make hardship withdrawals from a qualified cash or deferred arrangement or a tax-sheltered annuity or account.

Moreover, the committee is concerned that the present-law level of the additional income tax appears in many instances to be an insufficient deterrent to the use of retirement funds for nonretirement purposes, because for taxpayers whose income is taxed at a high marginal rate, the sanction may be neutralized by the tax-free compounding of interest after 5 or 6 years. Accordingly, the committee believes it to be appropriate to increase the tax from 10 to 15 percent. However, the committee recognizes that actual retirement may commonly commence before age 59½ in some industries and, therefore, provides an exception to the tax for the early commencement of a participant's benefits in the form of a life annuity.

Finally, the committee recognizes that the present-law prohibition on distributions from qualified cash or deferred arrangements upon plan termination imposes significant administrative burdens on the trustees of such plans who must administer the related trust until all participants have retired or separated from service.

Explanation of Provisions

Withdrawal restrictions

Under the bill, a qualified cash or deferred arrangement may make distributions on account of the plan's termination (provided no successor plan is established), as well as on account of the employee's death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan) attainment of age 59½. The bill provides that a distribution on account of the termination of a qualified cash or deferred arrangement must consist of the participant's total account balance under the plan. Distributions on account of hardship are permitted only to the extent of an employee's elective deferrals (but not income on those deferrals under the cash or deferred arrangement). Present law standards governing what constitutes a "hardship" continue to apply.

In addition, the withdrawal restrictions currently applicable to tax-sheltered custodial accounts generally are extended to other tax-sheltered annuities. Thus, early distributions from a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59½. In addition, withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions (sec. 3121(a)(5)(D)). The present-law standards defining "hardship" for purposes of a qualified cash or deferred arrangement will apply.

Additional income tax on early withdrawals

Under the bill, the 10-percent additional income tax on withdrawals from an IRA by the owner prior to attainment of age 59½, death, or disability is increased to 15 percent, and is extended to early withdrawals by any participant from any qualified retirement plan. Under the bill the term "qualified retirement plan" includes a qualified defined benefit or defined contribution plan, a tax sheltered annuity or custodial account, or an individual retirement arrangement.

An exemption from the tax is provided for any distribution that is part of a scheduled series of substantially equal periodic payments (made not less frequently than annually) for the life of the participant (or the joint lives of the participant and the participant's beneficiary). For example, distributions under a life annuity to a 50-year-old participant under a qualified plan under which normal retirement occurs after 30 years of service is exempt from the additional 15 percent income tax. Similarly, distributions under an annuity providing substantially equal periodic payments for the life of the participant or a term certain, whichever is longer, will be exempt from the additional tax.

The committee intends that, in the case of a defined contribution plan or IRA, the exemption from the tax is to be available only if the plan or IRA purchases a commercial annuity to fund the individual's benefit. With respect to a defined benefit pension plan, a series of payments will not fail to be substantially equal solely because the payments vary on account of (1) certain cost of living adjustments, (2) cash refunds of employee contributions upon an employee's death, (3) a benefit increase provided to retired employees, (4) an adjustment due to the death of the employee's beneficiary, or (5) the cessation of a social security supplement. The committee intends that the Secretary may prescribe regulations setting forth other factors that will not cause a benefit to fail to be considered substantially nonincreasing.

Effective Dates

The provisions generally are effective for years beginning after December 31, 1985. The provision permitting distributions from a cash or deferred arrangement upon plan termination applies to plan terminations after December 31, 1984.

The provisions relating to restrictions on distributions from tax-sheltered annuity or custodial accounts do not apply to amounts contributed to tax-sheltered annuities or custodial accounts before December 31, 1985.

The provisions relating to the additional income tax on early withdrawals apply to all distributions made in taxable years beginning after December 31, 1985. However, the bill contains an exception from the tax for individuals who, as of November 6, 1985, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. In addition, the requirement that benefits be paid pursuant to a written election designating a specific schedule of benefit payments will be deemed satisfied where the plan from which the benefits are paid provides for only one form of distribution, or where

(1) the plan provides that, in the absence of an election to the contrary, a participant will be paid benefits according to the automatic form of payment specified in the plan, and (2) the individual is, in fact, receiving benefits in that form.

The bill also exempts from the additional income tax on early withdrawals a total distribution of a participant's accrued benefit on account of a plan termination occurring prior to December 31, 1985. To be considered a distribution made on account of a plan termination, the distribution must be made within a reasonable time after the termination occurred.

3. Taxation of Distributions (sec. 1122 of the bill and secs. 72, 402 and 403 of the Code)

Present Law

In general

Generally, a distribution of benefits from a tax-favored retirement arrangement is includible in gross income. In the case of a distribution from a qualified plan or an IRA, such a distribution is includible in the year in which it is paid or distributed. Under a tax-sheltered annuity, benefits are includible in income when paid or made available.

Lump sum distributions

Under present law, a lump sum distribution from a qualified plan may qualify for special 10-year forward income averaging. In addition, the portion of a lump sum attributable to contributions prior to January 1, 1974, may qualify for capital gains treatment.

Basis recovery

Present law provides special rules for the treatment of basis (e.g., employee contributions) when an individual receives a distribution from a tax-favored retirement arrangement. If an amount is received before the annuity starting date (i.e., the date on which an amount is first received as an annuity), the individual is treated as first receiving employee contributions, which are nontaxable, and taxable income second.

In the case of amounts received after the annuity starting date, each payment received by an employee generally is treated, in part, as a return of the employee's contributions and, in part, as taxable income. The portion of each payment treated as a return of employee contributions is that amount that bears the same ratio to each payment as the employee's total contributions bear to his total expected payments over the period of the annuity. In the case of a straight life annuity the employee's life expectancy, as of his annuity starting date, is treated as the period over which the annuity is to be paid for purposes of computing his total expected return under the contract. Where the employee dies prior to the expiration of his anticipated life expectancy, no deduction is provided for the employee's unrecovered basis. On the other hand, an employee whose actual life is longer than anticipated at the time his benefits commence effectively excludes from income an amount in excess of the employee's total contributions.

In addition, under present law, a special rule applies under certain circumstances to annuity payments from qualified plans. Under the special rule, if an individual's first 3 years of annuity payments after the annuity starting date will equal or exceed the individual's aggregate employee contributions, all distributions are treated as a return of employee contributions (and thus nontaxable) until all of the individual's employee contributions have been recovered. Thereafter all distributions are fully taxable.

Reasons for Change

The application of the doctrine of constructive receipt to amounts held under a tax-sheltered annuity creates a needless disparity in the tax treatment of individuals covered by different types of tax-favored retirement arrangements.

The special 10-year averaging and capital gain provisions for lump sum distributions (including lump sum distributions before retirement) encourage individuals to withdraw tax-favored funds from the retirement income stream and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and 10-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals generally to roll over distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA. Because rollovers are permitted, the provision of income averaging and capital gains treatment are inappropriate incentives to consume retirement monies, especially with respect to distributions prior to age 59½. Thus the committee finds it appropriate to limit the availability of 5-year averaging and capital gains treatment.

Similarly, the basis recovery rules for early distributions permit the accelerated tax-free recovery of employee contributions and thus further encourage the use of tax-favored plans for nonretirement purposes.

Explanation of Provisions

Overview

The bill (1) repeals the rule that owners of tax-sheltered annuities are subject to tax when amounts under the annuities become available; (2) phases out capital gains treatment over 6 years; (3) eliminates 10-year forward averaging and permits 5-year forward averaging under limited circumstances; (4) reorders the present law basis recovery rules for amounts withdrawn prior to a participant's annuity starting date; (5) eliminates the special three year basis recovery rule of present law; and (6) modifies the general basis recovery rules for amounts paid as an annuity.

Constructive receipt under a tax-sheltered annuity

Under the bill, an owner of a tax-sheltered annuity is subject to tax only when benefits are actually received.

10-year averaging and pre-1974 capital gains treatment

The bill repeals 10-year forward averaging, phases out pre-1974 capital gains treatment over a 6-year period, makes 5-year forward averaging (calculated in the same manner as 10-year averaging under present law) available for one lump sum distribution received by an individual after age 59½ and permits certain individuals to apply 5-year averaging to one lump sum distribution received before age 59½.

Under the bill, individuals are permitted to make a one-time election with respect to a single lump sum received after the individual attains age 59½ (1) to claim, pursuant to the 6-year phase-out, capital gains treatment on that portion of the lump sum (if any) attributable to amounts contributed prior to 1974 and (2) to use 5-year forward averaging on the balance of the lump sum. In addition, the bill provides a special transition rule under which any participant who attains age 50 by January 1, 1986, is permitted to make one election with respect to a single lump sum distribution received prior to age 59½ (1) to claim pre-1974 capital gains treatment pursuant to the 6-year phase-out, and (2) to use 5-year forward averaging on the balance of the lump sum.

The bill also permits individuals who separate from service in December of 1985 and receive a lump sum distribution in January of 1986 to elect to treat the distribution as received in 1985 and to claim 10-year averaging (and capital gains treatment if appropriate) with respect to the distribution.

Basis recovery rules

The bill modifies the basis recovery rules applicable to distributions from plans in which there are after-tax employee contributions. Under the bill, amounts received prior to the annuity starting date are treated as being made first out of taxable amounts (employer contributions and income) and, second as being made out of nontaxable amounts (employee contributions). If an employee is only partially vested in the portion of his benefits attributable to employer contributions (for example, in the case of a class year plan), the employee is not taxed on a distribution to the extent that the distribution, when added to any prior distributions under the plan, exceeds the sum of (1) the employee's vested benefits attributable to employer contributions, plus (2) income on the employee's contributions.

With respect to amounts received after the annuity starting date, the special three-year basis recovery rule is eliminated. Thus, an employee must include in income a portion of each payment made on or after the employee's annuity starting date.

The bill provides that in computing the portion of each payment that may be excluded from income, the employee's expected total return is to be determined as of the date of the payment. The bill limits the total amount that an employee may exclude from income to the total amount of the employee's contribution. In addition, if an employee's benefits cease prior to the date the employee's total contributions have been recovered, the amount of unrecovered contributions is allowed as a deduction to the annuitant for his last taxable year. For purposes of the provisions of present law relating

to net operating losses, the deduction is treated as related to a trade or business of the employee.

Effective Dates

The provision relating to the constructive receipt of income under a tax-sheltered annuity is applicable to taxable years after December 31, 1985.

The provisions relating to the taxation of lump-sum distributions are effective for distributions made after December 31, 1985.

The provisions relating to the basis recovery rules for amounts received before a participant's annuity starting date are generally effective for distributions made after December 31, 1985, but do not apply to employee contributions made prior to January 1, 1986. Thus, except in the case of plans in which substantially all contributions are employee contributions, withdrawals made after the effective date, but prior to an individual's annuity starting date, are to be treated as made in the following order: (a) pre-1986 employee contributions, (b) all employer contributions whether pre-86 or post-85, but only to the extent vested, and all earnings on vested employer and employee contributions, and (c) post-1985 employee contributions.

The repeal of the special 3-year basis recovery rule generally is effective with respect to any individual whose annuity starting date is after July 1, 1986. In addition, under the bill, the special 3-year rule is available to employees who made a one-time election before November 22, 1985, to participate in a qualified pension plan and whose contributions were fixed after the election to participate.

4. Treatment of Loans (sec. 1134 of the bill and sec. 72 of the Code)

Present Law

An individual is permitted, under present law, to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated (sec. 4975). However, no loan is permitted under the Employee Retirement Income Security Act of 1974 (ERISA) or the Code from a qualified plan to an owner-employee (i.e., a sole-proprietor or more than 10-percent partner). Interest paid on a loan from a qualified plan is deductible (sec. 163).

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits. An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 or (2) the greater of $10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan must, by its terms, be repaid within five years or, if the loan is used to acquire or improve a

principal residence of the participant or a member of the participant's family, within a reasonable period of time.

Reasons for Change

The rules governing the tax treatment of loans from certain tax-favored plans are intended to limit the extent to which an employee may currently use assets held by a plan for nonretirement purposes and to ensure that loans are actually repaid within a reasonable period. However, there is concern that the present rules do not prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third parties.

In addition, the present law current rule permitting home loans with repayment periods extending beyond five years for family members of the employee and for certain improvements on existing principal residences is overly broad and difficult to apply. The committee believes that the favorable tax treatment of amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and that any exceptions to this general policy should be narrowly limited.

Explanation of Provision

The bill modifies the exception to the income inclusion rule by reducing the $50,000 limit on a loan by the participant's highest outstanding loan balance during the preceding 12-month period.

In addition, the extended repayment period permitted for purchase or improvement of a principal residence is amended to apply only to the purchase of the principal residence of the participant. Plan loans to improve an existing principal residence, to purchase a second home, and to finance the purchase of a home or home improvements for other members of the employee's family are subject to the 5-year repayment rule.

The bill also requires that a plan loan be amortized in level payments, made not less frequently than quarterly, over the term of the loan.

The bill also provides for the deferral of the deduction for interest paid by (1) all employees on loans secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity, and (2) key employees with respect to loans from any qualified plan or other tax-favored retirement plan. The deferral is to be accomplished by denying a current deduction for the interest paid and increasing the participant's basis under the plan by the amount of nondeductible interest paid.

Effective Date

The provisions would be effective for amounts received as a loan after December 31, 1985. Any renegotiation, extension, renewal, or revision after December 31, 1985, of an existing loan is treated as a new loan on the date of such renegotiation, etc.

Revenue Effects of Part C

The provisions are estimated to increase fiscal year budget receipts by $282 million in 1986, $993 million in 1987, $2,223 million in 1988, $3,114 million in 1989, and $3,584 million in 1990.

D. Limits on Tax Deferral

1. Adjustments to Limitations on Contributions and Benefits Under Qualified Plans (secs. 1103 and 1133 of the bill, secs. 415 and 4980A of the Code)

Present Law

In general

In order to limit the extent to which individuals can use tax-favored arrangements to provide for retirement, present law (sec. 415) provides overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and SEPs maintained by any private or public employer or by certain related employers.

Defined contribution plans

Dollar limit

Under a defined contribution plan,[18] the qualification rules provide a limit on the annual additions with respect to each plan participant (Code sec. 415(c)).[19] Under present law, the annual addition generally is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $30,000. Beginning in 1988, the dollar limit is to be adjusted for post-1986 cost-of-living increases.

Annual addition

Under present law, annual additions (sec. 415(c)) include employer contributions, forfeitures, certain employee contributions, and certain contributions for post-retirement medical benefits. The amount of nondeductible employee contributions taken into account as annual additions is the lesser of (1) one-half of the employee contributions, or (2) total employee contributions in excess of six percent of compensation. Therefore, if total employee contributions do not exceed six percent of compensation, no employee contributions are counted as annual additions. In addition, under present law, certain amounts having the effect of employer contributions may be treated as annual additions.

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[18] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants.

[19] For purposes of applying this limit, all defined contribution plans of an employer are treated as a single plan.

Defined benefit pension plans

Under present law, the limit on the annual benefit payable from a defined benefit plan[20] is the lesser of (1) 100 percent of average compensation, or (2) $90,000.[21] Beginning in 1988, the dollar limit is to be adjusted to reflect past-1986 cost-of-living increases. The annual benefit generally is the equivalent of an annuity for the life of the participant, beginning at age 62 or later, and determined without regard to certain survivor and nonretirement benefits.

Early retirement benefits

If retirement benefits commence before age 62, the dollar limit (but not the 100 percent of compensation limit) is reduced. Thus, for benefits commencing before age 62, the $90,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. In no event, however, is the dollar limit applicable to benefits commencing at or after age 55 less than $75,000. If retirement benefits commence before age 55, the dollar limit is actuarially reduced so that it is the actuarial equivalent of a $75,000 annual benefit commencing at age 55.

Under present law, the reduction in the dollar limit for benefits commencing before age 62, and the reduction in the $75,000 amount for benefits commencing before age 55, must be computed using an interest rate assumption not less than the greater of five percent or the rate specified in the plan for purposes of determining benefits payable before the normal retirement age. There is no required reduction for pre-retirement ancillary benefits (such as medical, death, or disability benefits), but adjustments are required to reflect post-retirement ancillary benefits such as term-certain annuities, post-retirement death benefits, etc.

If retirement benefits under a defined benefit plan begin after age 65, the $90,000 limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65. The increase is to be computed using an interest rate assumption not greater than the lesser of five percent or the rate specified in the plan.

These provisions do not prohibit an employee from retiring prior to age 62, and they do not mandate actuarial reductions in plan benefits commencing prior to age 62 where the limits are not exceeded. Similarly, present law does not require that a plan provide increased benefits for participants retiring after age 65.

Eligibility to receive maximum benefits

Under present law, reduced limits apply to participants with less than ten years of service. Both the dollar and percentage limits are reduced by ten percent per year for each year of service less than ten. For example, benefits commencing at or after age 62 with respect to a participant who had only three years of service generally

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[20] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

[21] For purposes of applying this limit, all defined benefit plans of an employer are treated as a single plan.

could not exceed the lesser of 30 percent of compensation, or $27,000 ($27,000 is 3/10 of the present-law $90,000 dollar limit).

A special de minimis rule, which generally permits payment of annual benefits not in excess of $10,000 for participants who have not at any time participated in a defined contribution plan maintained by the employer, similarly is reduced for participants with less than 10 years of service. For example, the de minimis benefit payable with respect to a participant who had only three years of service could not exceed $3,000 (3/10 of $10,000).

Cost-of-living increases

Beginning in 1988, the $30,000 and $90,000 limits are scheduled to be adjusted for post-1986 cost-of-living increases.

Combined plan limit

Present law also provides an aggregate limit applicable to employees who participate in more than one type of plan maintained by the same employer.

If an employee participates in a defined contribution plan and a defined benefit pension plan maintained by the same employer, the fraction of the separate limit used for the employee by each plan is computed and the sum of the fractions is subject to an overall limit (sec. 415(e)). Under present law, the sum of the fractions is limited to 1.0. Although the sum of the fractions is limited to 1.0, adjustments made to the denominators of the revised fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

Aggregate limit on contributions and benefits for key employees in a top-heavy plan

Under present law, the combined plan limit may be reduced for an employee who participates in both a defined benefit pension plan and a defined contribution plan that are top heavy. Unless certain requirements are met, for any year for which the plans are top heavy, the fractions are modified, effectively providing the employee with an aggregate limit equal to the lesser of 1.0 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

These modifications do not apply if the plans of the employer in which the employee participates (1) are not super top heavy (i.e., do not provide more than 90 percent of the benefits for key employees), and (2) provide either an extra minimum benefit (in the case of the defined benefit pension plan) or an extra minimum contribution (in the case of the defined contribution plan) for non-key employees participating in the plans.

Reasons for Change

Although Congress has provided tax incentives to encourage employer-provided retirement benefits, it also restricts the retirement savings of an employer that can receive tax-favored treatment under qualified plans of a particular employer. In evaluating these incentives, the committee concluded that the current dollar limits

($30,000 and $90,000, respectively) permit tax-favored retirement savings in excess of that needed to provide an adequate incentive for employers to maintain plans providing an adequate retirement income.

In considering the dollar limits, the committee focused not only on the dollar amounts appropriate for the separate plan limits, but also on the relative attractiveness of defined contribution and defined benefit plans, the appropriateness of cost-of-living increases, and the need to impose an aggregate limit on all tax-favored retirement savings accumulated on behalf of a particular participant.

The committee concluded that defined benefit pension plans provide better overall retirement income security because the participants in defined benefit pension plans are protected against bad investment experience and because many defined benefit pension plans may provide protection against inflation up to normal retirement age (because the benefits provided are often based on final average pay). Accordingly, while reducing the dollar limits for both defined benefit and defined contribution plans, the committee found it appropriate to provide for a gradual change in the ratio between those limits.

In addition to establishing a more appropriate dollar limit, the committee is concerned about the impact of inflation on those limits. Although the committee recognizes that cost-of-living adjustments can be accomplished by periodic Congressional action, the committee concludes it is more appropriate to provide for automatic adjustments beginning in 1988, as scheduled under present law.

The committee also questions why the overall limits are applied separately with respect to each employer and why retirement savings accumulated in IRAs are not taken into account. The committee concluded that the overall limits were adopted to limit the total amount that could be accumulated on behalf of a participant on a tax-favored basis. Thus, the committee believes that there is no need to distinguish between employer and employee contributions in applying these limits. Similarly, the committee believes that there is no need to permit a participant to accumulate multiple maximum benefits from several employers as well as individual savings in an IRA. Accordingly, the committee found it appropriate to count all employee contributions fully in applying the annual limit and to impose an excise tax on certain excess retirement distributions.

In addition, the committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The committee is aware that some employers time the establishment of a defined benefit plan (or an increase in benefits under a pre-existing plan) to coincide with projected retirement of one or more of the employer's highly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who have retired prior to the highly compensated employee. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employee accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and vested in) greater ben-

efits. Thus, the committee finds it appropriate to require ten years of participation in a defined benefit pension plan before a participant can receive the maximum benefit.

Explanation of Provisions

Overview

The bill makes several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on the annual addition under defined contribution plans is decreased from $30,000 to the greater of $25,000 or 25 percent of the defined benefit plan dollar limit. The dollar limit on the annual benefit payable under defined benefit plans is decreased from $90,000 to $77,000.

If the retirement benefit under a defined benefit plan begins before age 62, the $77,000 limitation generally is reduced so that it is the actuarial equivalent of an annual benefit of $77,000 beginning at age 62.

Under transition rules provide by the bill, benefits already accrued by a plan participant under an existing plan are not affected by the reductions.

Although cost-of-living adjustments will be made to the defined benefit plan limit beginning in 1988, no cost-of-living adjustments to the defined contribution plan limit will be made until the $25,000 limit is equal to 25 percent of the defined benefit dollar limit, at which point the defined contribution plan limit will be increased to maintain the 25-percent ratio.

Finally, the bill adds a new excise tax on excess retirement distributions.

Defined contribution plans

The dollar limit on the annual additions for an employee under defined contribution plans of an employer is decreased from $30,000 to the greater of $25,000 or 25 percent of the defined benefit plan dollar limit. The 25 percent of compensation limit is not changed.

In addition, the bill modifies the definition of annual addition to include all employee contributions, including employee contributions less than six percent of compensation.

Defined benefit pension plans

In general

The bill reduces the dollar limit on employer-derived annual benefits for an employee under defined benefit plans from $90,000 to $77,000. The 100 percent of compensation limit is not changed. As under present law, the value of benefits paid in a form other than a single life annuity may not exceed the actuarial equivalent of a single life annuity equal to the applicable limit (the lesser of the dollar or percentage limit).

Dollar limits for benefits payable upon early or delayed retirement

In general.—Under the bill, if retirement benefits under a defined benefit plan begin before age 62, the $77,000 limit (but not the 100 percent of compensation limit) generally is reduced so that it is the actuarial equivalent of an annual benefit of $77,000 beginning at age 62. However, the bill provides that in no event will the dollar limit for benefits commencing at or after age 55 be reduced below $65,000. Thus, the dollar limit for benefits which commence at or after age 55 and before age 62 will be the greater of (1) the actuarial equivalent of the usual, inflation-adjusted, dollar limit ($77,000 for 1986) for benefits commencing at age 62, or (2) $65,000. In addition, for benefits commencing before age 55, the applicable dollar limit will be the greater of (1) the actuarial equivalent of the usual, inflation-adjusted, dollar limit for benefits commencing at age 62, or (2) the actuarial equivalent of a $65,000 annual benefit commencing at age 55.

As under present law, the reduction in the dollar limit ($77,000) for benefits commencing before age 62, and the reduction in the limit for benefits commencing before age 55 ($65,000), must be computed using an interest assumption not less than the greater of five percent or the rate specified in the plan for purposes of determining benefits payable before the normal retirement age. As under present law, there is no required reduction for pre-retirement ancillary benefits (such as medical, death, or disability benefits), but adjustments are required to reflect post-retirement ancillary benefits such as term-certain annuities, post-retirement death benefits, etc.

Special rules for airline pilots, police, and firefighters.—In addition, the bill provides special rules for commercial airline pilots, and participants in a qualified police or firefighters' pension plan.

Federal regulations require that commercial airline pilots retire after attaining age 60. The committee believes that it is inappropriate to require actuarial reduction in the dollar limit on benefits payable under these circumstances. Accordingly, under the bill, the reduction for early retirement would apply only to those airline pilots whose benefits begin before age 60 and the dollar limit applicable to annual benefits beginning at age 60 would be $77,000. Of course, if benefits begin before age 60, the dollar limit applicable to annual benefits will be determined under the general rules. Under those rules, the limit on annual benefits commencing after attainment of age 55 but before age 60 is the actuarial equivalent of $77,000 beginning at age 62 (but in no event less than $65,000).

Similarly, the committee believes it is inappropriate to provide full actuarial reduction of the limit on benefits payable to participants in a qualified police or firefighters' pension plan. The bill provides that the dollar limit on benefits payable to participants in a qualified police or firefighters' pension plan will never be actuarially reduced to an amount less than $50,000, regardless of the age at which benefits commence.

For purposes of this provision, a qualified police or firefighters' pension plan is defined as a defined benefit plan maintained by a State (or political subdivision thereof) for the benefit of all full-time

employees of any police or fire department organized and operated by such State or political subdivision to provide police protection, fire-fighting services, or emergency medical care. In addition, a qualified police or firefighters' pension plan must (1) limit service taken into account to service with a police or fire department (or the armed services of the United States); and (2) require, as a condition to the payment of benefits, at least 20 years of service.

(Delayed retirement).—The bill also modifies the present-law rule permitting an increased limit with respect to benefits commencing after attainment of age 65 to take into account the reduction in the limits. Accordingly, under the bill, if retirement benefits under a defined benefit plan begin after age 65, the $77,000 limit is increased so that it is the actuarial equivalent of an annual benefit of $77,000 beginning at age 65. As under present law, the increase is to be computed using an interest rate assumption not greater than the lesser of five percent or the rate specified in the plan.

Of course, this provision does not prohibit an employee from retiring prior to age 62, and it does not mandate actuarial reductions in plan benefits commencing prior to age 62 where the limits are not exceeded. Similarly, the bill does not require that a plan provide increased benefits for participants retiring after age 65.

Eligibility to receive maximum benefits

Under the bill, reduced limits apply to participants with fewer than 10 years of participation in the defined benefit plan (sec. 415(b)(5)). The dollar limit on benefits payable from a defined benefit plan (but not the percentage limit) generally is reduced by ten percent per year for each year of participation in the plan less than 10. In no event, however, is the limit reduced to an amount less than one-tenth of the dollar limit (under the bill, $7,700). Thus, service with the employer prior to becoming a participant under the plan is disregarded in determining the dollar limit on benefits payable. For example, if a participant who would otherwise be entitled under the terms of the plan to receive the maximum annual benefit (under the bill, $77,000 for 1986) had only three years of participation in the plan (regardless of the number of years of service), the maximum benefit payable would be the lesser of 100 percent of compensation, or $23,100 (3/10ths of $77,000).

Except as provided in regulations to be issued by the Secretary of the Treasury, a new ten-year period of participation will be required with respect to increases in the otherwise applicable limit made available through changes in the benefit structure (whether made by plan amendment or otherwise). In general, no participant will be entitled to the full amount of the increased limit until they complete ten years of participation after the change in benefit structure. The Secretary of the Treasury is to prescribe regulations defining those changes in benefit structure for which a new ten-year period of participation would not be required. The committee generally does not intend plan provisions that incorporate cost-of-living increases (within the meaning of section 415(d)) to be treated as changes in benefit structure requiring an additional ten years of participation. However, to the extent that cost-of-living increases or post-retirement benefit increases are inconsistent with the purposes of this benefit limit, the committee does intend such in-

creases to be subject to this rule. In addition, the bill authorizes the Secretary of the Treasury to issue regulations for the application of this rule in situations involving plan mergers or spin-offs.

The bill retains the present-law provision that phases in the special $10,000 de minimis benefit based on years of service.

Cost of living adjustments

The bill retains the present-law cost-of-living adjustments for the defined benefit plan dollar limit (sec. 415(d)). Thus, beginning in 1988, the $77,000 defined benefit dollar limit will be adjusted to reflect post-1986 cost-of-living increases. However, cost-of-living adjustments to the $25,000 defined contribution plan dollar limit will be temporarily suspended until that limit is equal to 25 percent of the defined benefit dollar limit. Thereafter, cost-of-living adjustments will be provided, effectively ensuring that the defined contribution plan dollar limit will be equal to the greater of $25,000 or 25 percent of the defined benefit plan limit.

As under present law, anticipated cost-of-living adjustments to the overall benefit limits may not be taken into account under the rules relating to the deduction allowed for employer contributions to a qualified plan.

Qualified cost-of-living arrangement

In general

The bill also permits a defined benefit plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit. A qualified cost-of-living arrangement is defined as an arrangement under a defined benefit plan that complies with the limits, election procedures, and nondiscrimination requirements of the bill, as well as such other requirements as the Secretary of the Treasury may prescribe by regulations.

Of course, a qualified cost-of-living arrangement must satisfy all of the applicable qualification requirements of section 401(a) not specifically altered or made inapplicable by the bill. For example, the right to the employer-provided portion of a cost-of-living benefit under a qualified arrangement is part of the accrued benefit subject to section 411 (including section 411(d)(6)) and thus will accrue and vest as the employee accrues and vests in the normal retirement benefit. Thus, an employer may reduce or eliminate the employer contribution under a qualified cost-of-living arrangement only with respect to benefits not yet accrued.

Similarly, such cost-of-living increases must be available on the same terms for all participants. Thus, a greater subsidy could not be provided for employees who work until retirement than to those who separate from service with vested benefits prior to retirement.

A qualified cost-of-living arrangement satisfies the limit requirement added by the bill if it (1) limits cost-of-living adjustments to those increases occurring after the annuity starting date, and (2) bases the cost-of-living adjustment on average cost-of-living increases determined by reference to one or more indexes prescribed by the Secretary (or three percent).

A cost-of-living arrangement meets the election requirements added by the bill if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election (1) in the year in which the participant attains the earliest retirement age under the defined benefit plan, or separates from service, or (2) both such years.

A cost-of-living arrangement meets the nondiscrimination rules added by the bill only if the arrangement does not discriminate in favor of highly compensated employees as to eligibility to participate.

Special rule for key employees

Under the bill, key employees generally are precluded from participating in a qualified cost-of-living arrangement. However, in a plan that is not top heavy, officers who are key employees solely by reason of their status as officers may participate. For purposes of this rule, key employee has the same meaning as it does for top-heavy plans (sec. 416(i)).

Treatment of contributions to qualified cost-of-living arrangements

Under the bill, any employee contribution made to a qualified cost-of-living arrangement will not be treated as an annual addition for purposes of the annual limit (sec. 415(c), but will be treated as an annual limit for purposes of applying the combined plan limit (sec. 415(e)). However, the benefit attributable to such employee contribution will be treated as an employer-provided benefit (for purposes of section 415(b)).

Combined plan limit; excess distributions

In general

The bill retains the present-law combined plan limit applicable to employees who participate in both a defined benefit plan and defined contribution plan maintained by the same employer.

In addition, the bill imposes a new excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs (sec. 4980A). To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement savings arrangements are excess distributions, the bill generally imposes an excise tax equal to 15 percent of the excess.

In applying the limit, aggregate annual distributions made with respect to a participant from all pension, profit-sharing, stock bonus, and annuity plans, ESOPs, individual retirement accounts and annuities (IRAs), and tax-sheltered annuities generally are taken into account to the extent includible in gross income. However, the bill provides that certain amounts are excluded in making this calculation. Under the bill, excludable distributions include (1) amounts representing a return of employee after-tax contributions (but not earnings thereon); (2) amounts excluded from the participant's income because they are rolled over into another plan or individual retirement savings arrangement; and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec.

414(p)) and includible in the spouse's income. Of course, distributions payable to the former spouse are aggregated with any other retirement distributions payable to such spouse for purposes of determining whether the spouse has excess retirement distributions subject to the tax. (Distributions paid to other alternate payees (e.g., minor children) are includible in applying the limit.) In addition, distributions made with respect to a participant after the death of the participant are disregarded in applying this annual limit and are subject instead to an additional estate tax.

Under the bill, excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of $112,500 or 125 percent of the defined benefit plan dollar limit applicable to benefits commencing at or after attainment of age 62. For example, for 1986, the ceiling will be $112,500 because $112,500 is greater than $96,250 (125 percent of $77,000). Accordingly, a participant receiving aggregate annual distributions of $152,500 in 1986 will be subject to an excise tax of $6,000 (15 percent of the $40,000 excess distributions).

Under this provision, the ceiling amount is not adjusted to reflect the age at which benefit payments commence. Thus, the limit is neither decreased to reflect early commencement of benefits nor increased to reflect deferred commencement. However, this tax will not apply to those distributions subject to the 15-percent additional income tax on early distributions (sec. 72(t), as added by the bill).

In applying the additional tax, all distributions made with respect to any individual during a calendar year will be aggregated, regardless of the form of the distribution or the number of recipients. Thus, for example, all distributions received during a year, whether paid under a life annuity, a term certain, or any other benefit form (including an ad hoc distribution) generally will be aggregated in applying the tax.

Lump sum distributions

A special higher ceiling applies for purposes of calculating the excess distribution for any calendar year in which an individual receives a lump sum distribution that is taxed under the favorable long-term capital gains or five-year averaging rules. The higher ceiling will be the lesser of (i) the portion of the lump sum distribution that is treated as long-term capital gains or taxed under the five-year averaging rules, or (ii) five times the otherwise applicable ceiling for such calendar year. Thus, for example, if in 1990 an individual receives a $300,000 lump sum distribution and elects to tax such amount under the five-year averaging rules, the special higher ceiling applicable for calculating the individual's excess distribution for the year is the lesser of (i) $300,000, or (ii) five times the otherwise applicable ceiling for the year ($562,500, assuming an otherwise applicable ceiling for 1990 of $112,500). Accordingly, no part of this individual's lump sum distribution taxed under the five-year averaging rules would be treated as an excess distribution subject to the 15-percent additional tax. Of course, if this individual also received other retirement distributions during 1990, such other distributions would be in excess of the higher ceiling and thus would be treated as excess distributions.

Post-death distributions

The bill provides special rules to calculate the extent to which retirement distributions made with respect to a participant after the participant's death are excess distributions. In lieu of subjecting post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the bill adds an additional estate tax equal to 15 percent of the individual's excess retirement accumulation (sec. 4980A). After the estate tax is imposed, post-death distributions are disregarded entirely in applying this tax. For example, beneficiaries who are receiving distributions with respect to a participant after the participant's death (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their own behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retirement plans, tax-sheltered annuities, and individual retirement accounts, over the present value of annual payments equal to the annual ceiling ($112,500 or, if greater, 125 percent of the applicable defined benefit plan dollar limit in effect on the date of death), over a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all plans, tax-sheltered annuities and individual retirement arrangements will be taken into account regardless of the number of beneficiaries. In addition, the decedent's interests are to be valued as of the date of death or, in the case of a decedent for whose estate an alternate valuation date had been elected, such alternate valuation date (sec. 2032).

Includible compensation

To ensure that the reduction in the overall dollar limits does not cause decreases in the levels of contributions or benefits provided to non-key employees, the bill provides a limit on the compensation that may be taken into account under a plan. The $200,000 limit presently applicable to top-heavy plans is reduced to an amount equal to seven times the defined contribution plan dollar limit (under the bill, for 1986, seven times $25,000 or $175,000) and applied to all qualified plans, whether or not top-heavy (sec. 401(a)(17)). The limit on includible compensation will be increased as the defined contribution plan dollar limit is increased. This limit applies for all purposes in testing for discrimination (*e.g.*, secs. 401(a)(4) and sec. 401(k)(3)).

Effective Dates

Reductions in the overall limits

The provisions generally apply to years beginning after December 31, 1985. However, a plan will not fail to be qualified for any year beginning before January 1, 1988, merely because the plan provides benefits or contributions that, though not exceeding the overall limits in effect prior to the amendments made by the bill,

exceed the limits as amended. However, employer deductions with respect to years beginning after December 31, 1985, will be limited to those amounts required to fund the lower limits provided by the bill (whether or not contributions required by the plan or the minimum funding standard (sec. 412) exceed those limits). In addition, no later than the first plan year beginning after December 31, 1987, benefits in excess of the greater of the amended limit or an individual's current accrued benefit must be reduced, to conform to the limits as amended.

Collectively bargained plans

The bill provides a special effective date for plans maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers. Under the bill, the new limits on benefits and contributions will not apply to years beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates, or (ii) January 1, 1991. For this purpose, any extensions of the collective bargaining agreement agreed to after November 21, 1985, will be disregarded. In addition, any plan amendment that amends the plan solely to conform to the amendments made by the bill (with respect to benefit limits and distribution requirements) will not be considered a termination or extension of the collective bargaining agreement.

Transitional rules relating to current accrued benefits

The bill also provides a transitional rule to insure that a participant's previously accrued benefit under a defined benefit pension plan is not reduced merely because the bill reduces the dollar limits on benefits payable under the plan or increases the period of participation required to earn the maximum benefit. The rule applies with respect to an individual who is a participant before January 1, 1985, in a plan that was in existence on November 6, 1985. If such an individual has a current accrued benefit that exceeds the bill's dollar limit (but does not exceed the dollar limit in effect under prior law), then the applicable dollar limit for the individual is equal to that current accrued benefit. Similarly, in computing the participant's defined benefit fraction, the current accrued benefit would replace the dollar limit otherwise used in the denominator of the fraction.

Under the bill, an individual's current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before January 1, 1986, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the bill.

For purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after November 6, 1985, is taken into account. Accordingly, if an individual's current accrued benefit is a specified percentage of average pay, rather than a specified amount, the current accrued benefit is the specified percentage of the average pay computed as of the close of the last year beginning before 1986, based upon compensation paid up to that time. Although subsequent salary increases might increase the benefit to which a participant is entitled under

the plan, those increases would not increase the participant's current accrued benefit. Similarly, cost-of-living adjustments occurring after 1985 are not taken into account in computing the current accrued benefit. In addition, with respect to an individual whose annual benefit is treated as not exceeding the annual benefit limit (sec. 415(b)) on account of the transitional rule provided by section 2004(d)(2) of the Employee Retirement Income Security Act of 1974, or section 237(g) of the Tax Equity and Fiscal Responsibility act of 1982 (TEFRA), the individual's accrued benefit is the individual's annual benefit or the current accrued benefit as defined therein.

The bill does not affect the obligation of a plan to provide the current accrued benefit and the bill does not affect the consequences of an employer's failure to fund an individual's current accrued benefit. However, benefits accruing in years beginning after December 31, 1985, are not protected by this transitional rule. No later than the first plan year beginning after December 31, 1987, any accruals in excess of the greater of (1) the limit, as amended by the bill, or (2) the current accrued benefit described above, must be reduced (whether or not the participant's benefits are in pay status). Consistent with changes made by the Retirement Equity Act of 1984, the committee intends that such reductions to conform the plan to the limits, as amended, will not be considered a violation of the rules precluding a reduction in accrued benefits (sec. 411(d)(6)). Thereafter, no further accruals will be permitted for an individual whose current accrued benefit exceeds the bill's usual dollar limit until that dollar limit, as adjusted for cost-of-living increases, exceeds the individual's current accrued benefit.

With respect to a plan maintained pursuant to one or more collective bargaining agreements ratified before November 6, 1985, the current accrued benefit of an individual is the individual's accrued benefit as of the close of the last year beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates, or (ii) January 1, 1991.

Employee contributions treated as annual additions

The provision treating all employee contributions as annual additions generally is effective for years beginning after December 31, 1985. However, for purposes of calculating the defined contribution plan fraction and applying the combined plan limit (sec. 415(e)), the present-law rules will still apply in calculating the fraction applicable to years beginning before January 1, 1986. Thus, the defined contribution plan fraction applicable to years beginning before January 1, 1986, need not be recalculated to conform to the new definition of annual additions.

Tax on excess distributions

The 15-percent tax on excess distributions applies to benefits received in taxable years beginning after December 31, 1985.

2. Adjustments to Section 404 Limitations (sec. 1131 of the bill and secs. 404 and 4972 of the Code)

Present Law

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. Under present law, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. However, no deduction is allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Profit-sharing and stock bonus plans

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid (sec. 404(a)(3)). If employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years (within limits). If, however, the contribution for a particular year is less than the maximum amount for which a deduction is allowed, then the unused limitation (i.e., the limit carryforward) may be carried over and used in later years. In the case of a limit carryforward, the total amount that may be deducted in a later year may not exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined benefit pension plans

In general

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[22]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current

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[22] Under the minimum funding standard, the normal cost of a plan for a year is required to be funded currently. (The normal cost of a plan for a year is the cost of benefits earned in that year.) Past service costs are required to be spread over a period of years. (The amortization period depends on the origin of the past service cost and on the funding method used by the plan.) Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

service credits of all employees under the plan (adjusted if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least five taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years (sec. 404(a)(1)).

Minimum funding

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. Each funding method allocates total costs between the "normal cost" which is generally required to be funded currently and "past service costs" which are spread over a period of years.

Carryover of certain excess contributions

The minimum funding standard includes a provision (the full funding limitation) designed to eliminate the requirement that additional employer contributions be made for a period during which it is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of the full funding limitation.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

A pension, profit-sharing, or stock bonus plan does not meet the requirements of the Code for qualified status unless it is for the exclusive benefit of employees and their beneficiaries. Under some circumstances, employer contributions in excess of the level for which a deduction is allowed may indicate that the plan is not being maintained for the exclusive benefit of employees.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible to the extent required by the minimum funding standard. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

Combination of pension and other plans

If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or a stock bonus plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution necessary to meet the minimum funding requirements of the pension plan for the year.

The limit applies, for example, if an employer maintains both a defined benefit pension plan and a profit-sharing plan for the same employee for a year. The limit does not apply, however, if the employer maintains both a defined benefit pension plan and a money purchase pension plan for the same employee for the same year because both plans are pension plans.

Reasons for Change

The committee questions whether the present law deduction limits appropriately restrict employer contributions to qualified plans to amounts necessary to provide a reasonable level of retirement income security.

With respect to the 15-percent limit on annual contributions to a profit-sharing or stock bonus plan, the committee is concerned that application of the limit based on aggregate compensation may provide an incentive to allocate a greater proportion of employer contributions to more highly compensated employees by, for example, integrating those contributions with social security. Accordingly, in applying both the 15-percent and the 25-percent limits, the committee believes it is appropriate to permit an employer to deduct contributions only to the extent that the contributions, when added to the employer's share of social security taxes taken into account, directly or indirectly, under the plan, do not exceed the applicable percentage of aggregate compensation. The committee also questions whether it is appropriate to provide limit carryforwards.

In addition, the committee is aware that larger deductions for plan contributions are available to an employer that maintains a defined benefit plan and a money purchase pension plan than would be allowable if the employer maintained a defined benefit plan and an annuity, profit-sharing, or stock bonus plan. Because a money purchase pension plan is a defined contribution plan under which an employee accumulates benefits in an individual account in much the same manner as in a profit-sharing or stock bonus plan, the committee believes that a combination of a money purchase pension plan and a defined benefit plan should be subject to the same overall deduction limit as a combination of defined benefit plan and an annuity, profit-sharing, or stock bonus plan.

The committee also believes that it is inappropriate to permit an employer to make contributions in excess of the deduction limits and benefit from the tax-free compounding on income derived from assets acquired with excess contributions.

Explanation of Provisions

Overview

The bill makes several changes to the limits on employer deductions for contributions to qualified plans. The bill (1) repeals the limit carryforward applicable to profit-sharing and stock bonus plans; (2) extends the combined plan deduction limit to any combination of a defined benefit pension plan and a money purchase pension plan; (3) requires that certain social security taxes be taken into account in applying the 15-percent and 25-percent of

compensation deduction limits; and (4) imposes a 10-percent excise tax on excess contributions to qualified plans.

Elimination of limit carryforward

In general

Under the bill, as under present law, the contribution of an employer to a qualified profit-sharing or stock bonus plan is generally deductible in the taxable year when paid. The employer's deduction for such a contribution generally may not exceed 15 percent of the compensation otherwise paid or accrued during the taxable year to employees who benefit under the plan.

However, the bill generally repeals limit carryforwards for a profit-sharing or stock bonus plan. Accordingly, if an employer's contribution for a particular year is less than the maximum amount for which a deduction may be allowed, the unused limit may not be carried forward to subsequent years.

The bill does not change the rules of present law relating to deduction carryforwards. Accordingly, as under present law, any amount paid into a profit-sharing or stock bonus trust in excess of the 15-percent deduction limit for the year is to be deductible in the succeeding taxable years in order of time.

Pre-1986 limitation carryforwards

The bill does not eliminate limitation carryforwards accumulated in the past. Under the bill, the deduction limit for any taxable year beginning after December 31, 1985, may be increased by the unused pre-1986 limitation carryforwards (but not to an amount in excess of 25 percent of compensation otherwise paid or accrued in that year to employees who benefit under the plan).

The bill defines the unused pre-1986 limitation carryforward applicable to any taxable year as the amount by which the 15-percent limit applicable to a profit-sharing or stock bonus plan (as in effect on the day before the date of enactment of the provision) for any taxable year beginning before January 1, 1986, exceeds the amount paid to the trust for that taxable year (to the extent the excess was not taken into account in any taxable year prior to the year for which the limit is being calculated).

Combinations of pension and other plans

The bill applies the combined plan limit of present law to any combination of defined benefit and defined contribution plans if any employee benefits under the combination of plans (sec. 404(a)(7)).

Under the bill, if an employer contributes to 1 or more qualified defined contribution plans (1 or more qualified money purchase pension plans, profit-sharing plans, or stock bonus plans) and 1 or more qualified defined benefit pension plans for a taxable year, then the amount deductible in that taxable year under the overall deduction limits applicable to the plans (sec. 404(a)(7)) is not to exceed the greater of (1) 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees who benefit under the plans, or (2) the amount of contributions made to or under the defined benefit pension plan to the extent necessary to

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meet the minimum funding standard for that plan (sec. 412). As under present law, the otherwise applicable limits with respect to qualified pension, profit-sharing, and stock bonus plans (sec. 404(a)(1), (2) and (3)) are not reduced by the overall limit on deductions if no employee benefits under both a defined benefit pension plan and a defined contribution plan. A money purchase pension plan that amends the plan contribution formula to limit required contributions to those that are deductible will not be treated as failing to provide definitely determinable benefits. The bill makes no change to the present law provisions permitting deduction carryforwards.

Limitation reduced by certain Social Security taxes

The bill also takes certain employer-paid social security taxes (the OASDI portion of FICA and SECA taxes) into account in determining the applicable deduction limits. Under the bill, employer contributions to a qualified profit-sharing or stock bonus plan will be deductible to the extent that the contributions, when added to the OASDI tax taken into account under the profit-sharing or stock bonus plan, do not exceed 15 percent of aggregate compensation (25 percent of compensation in the case of the combined plan limit.) Thus, to the extent that FICA or SECA tax is treated directly or indirectly as an employer contribution to a profit-sharing or stock bonus plan in testing the plan for discrimination, that tax is also taken into account in computing the 15-percent limit on deductions for employer contributions. Similarly, employer-paid social security taxes taken into account under a profit-sharing or stock bonus plan are taken into account in determining which plans are subject to the 25-percent limit and in computing that limit. Corresponding rules apply to a simplified employee pension (SEP). Similar rules apply to the extent that employer contributions to a profit-sharing or stock bonus plan are coordinated with any similar retirement benefits created under State, Federal, or foreign law.

Excise tax on excess contributions to qualified plans

In general

Under the bill, a 10 percent nondeductible excise tax is imposed on excess contributions to a qualified pension, profit-sharing, stock bonus, or annuity plan (sec. 4972). Excess contributions are defined as the sum of (1) total amounts contributed for the taxable year over the amount allowable as a deduction for that year and (2) the amount of the excess contributions for the preceding year, reduced by amounts returned to the employer during the year, if any, and the portion of the prior excess contribution that is deductible in the current year. Thus, in effect, if an excess contribution is made during a taxable year, the excise tax would apply for that year and for each succeeding year to the extent the excess is not eliminated.

Under the bill, excess contributions for a year are determined as of the close of the employer's taxable year. Accordingly, a contribution made on account of a year but after the close of the year would be taken into account in determining the level of excess contributions for the year.

Similarly, if employer contributions for a particular year are subsequently determined to be nondeductible, the amount by which employer contributions actually made exceeds the amount determined to be deductible generally is treated as an excess contribution subject to this 10 percent tax. Moreover, under the bill, the tax on excess contributions applies in addition to any other taxes or penalties that may be appropriate (for example, the penalty on overvaluation of deductions for pension liabilities (sec. 6659A)). However, the tax generally does not apply to amounts that, but for the fact that they are taken into account as capital expenses within the meaning of section 451, would otherwise be allowable as a deduction (pursuant to section 404).

Employer

The tax is imposed on the employer. Under the bill, in the case of a plan that provides contributions or benefits for employees some or all of whom are self-employed individuals (sec. 401(c)(1)), an individual who owns the entire interest in an unincorporated trade or business is treated as the employer. Also, under the bill, a partnership is treated as the employer of each partner who is considered to be an employee (sec. 401(c)(1)).

Computation of amount subject to tax

Under the bill, the amount subject to the tax is the excess of the amount contributed to a qualified employer plan by the employer for the taxable year (increased by the unapplied amount subject to the tax in the previous year) in excess of the amount allowable as a deduction for that year. The unapplied amount subject to tax in the previous year is the amount subject to the tax in the previous year reduced by the sum of (1) the portion of that amount that is returned to the employer during the taxable year, and (2) the portion of that amount which is deductible during the year. However, the bill does not modify the rules of the Code or ERISA under which an employer may be allowed to withdraw certain amounts held by a pension, profit-sharing, or stock bonus plan.

For example, assume that an employer made an excess contribution of $100,000 for its taxable year beginning in 1986, that the employer made a small contribution for its 1987 taxable year, and that the level of excess contributions determined as of the close of its 1987 taxable year was $25,000. Under the bill, the excise tax would apply to excess contributions of $100,000 for the 1986 taxable year and $25,000 for the 1987 taxable year. On the other hand, if the excess was eliminated as of the close of the 1987 taxable year because the employer made no contribution for such year and the $25,000 excess contribution was deductible as a carryover, then the excise tax would apply only with respect to the 1986 taxable year.

Effective Date

The provisions relating to deduction limits generally apply to employer taxable years beginning after December 31, 1985. However, certain unused pre-1986 limit carryforwards are not affected by the provision generally repealing limit carryforwards.

3. Excise Tax on Reversion of Qualified Plan Assets to Employer (sec. 1132 of the bill and sec. 4980 of the Code)

Present Law

A qualified plan must be for the exclusive benefit of employees (sec. 401(a)). Generally, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees (sec. 401(a)(2)). However, if assets remain in a defined benefit plan upon plan termination[24] as a result of actuarial error, then after the plan has satisfied all liabilities those assets may be paid, as a reversion, to the employer.[25] Generally, a surplus is considered to be due to actuarial error if it is not due to specific action of the employer such as decreasing employer liabilities. In general, no amounts may be reverted to an employer upon termination of a defined contribution plan. However, certain amounts properly allocated to a suspense account under a defined contribution plan pursuant to Treasury Regulations Section 1.415-6(b)(6) may be reverted to the employer upon plan termination if the plan so provides.

Reasons for Change

The committee believes that it is appropriate to limit the tax incentives appropriate for retirement savings to the amount actually applied to provide retirement income. To the extent that amounts are not used for retirement purposes and revert to an employer, the committee believes that the tax treatment of reversions should recognize that earnings on pension funds are tax-free and, thus, the benefits of this tax treatment should be the recaptured. Although the committee believes that it might be possible to determine the particular year or years in which contributions resulting in a reversion arose and to recoup the resulting tax benefit attributable to a reversion on that basis, the committee is concerned that such a computation would involve undue complexity. Under the circumstances, therefore, the committee determined that a nondeductible excise tax should be imposed on reversions at a uniform rate.

Explanation of Provisions

In general

The bill imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the person who receives the reversion. Under the bill, the tax applies to amounts received as a reversion pursuant to the termination of a plan occurring after December 31, 1985.

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[24] Under present law procedural guidelines developed jointly by the Department of the Treasury, the Department of Labor and the PBGC, (The "Implementation Guidelines") set forth rules for certain terminations of qualified defined benefit pension plans involving reversions of excess assets.

[25] In addition, the Employee Retirement Income Security Act of 1974 (ERISA) provides that certain contributions may be returned to employers if (1) the contribution is made by mistake of fact; (2) the contribution is conditioned on initial plan qualification and the plan does not qualify; or (3) the contribution is conditioned on its deductibility and the deduction is disallowed. *See* Rev. Rul. 77-200, 1977-1 C.B. 98.

Under the bill, the excise tax applies to a reversion from a plan (or from a trust under a plan) if the plan met the requirements of the Code for qualified status (sec. 401(a) or sec. 403(a)) at any time or if the plan was, at any time, determined to have met those requirements by the Internal Revenue Service.

Amount of reversion

The bill defines a reversion as the amount of cash and the fair market value of other property received from a plan after the satisfaction of all liabilities under the plan with respect to employees and their beneficiaries. The amount of the reversion does not include any amount distributed to any employee (or beneficiary) if such amount could have been distributed before the termination of the plan without violating the plan qualification requirements (secs. 401(a) and 403(a)). However, the provision of a benefit or other obligation that causes the disqualification of a plan (or would cause the disqualification of the plan if it were otherwise qualified) is to be taken into account as a reversion if it is provided pursuant to the termination of the plan. For example, if benefits under a plan are increased to a level in excess of the overall limits on contributions and benefits, and if the increase is related to or in contemplation of the termination of the plan, then the value of the excess benefits is to be treated as a reversion.

Effective Date

The excise tax on reversions applies to a reversion received pursuant to a plan termination occurring after December 31, 1985. For purposes of this provision, a termination is considered to occur on the proposed date of termination.

Revenue Effect of Part D

The provisions are estimated to increase fiscal year budget receipts by $155 million in 1986, $427 million in 1987, $466 milion in 1988, $524 million in 1989, and $592 million in 1990.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Plan Amendments Not Required Until January 1, 1988 (sec. 1137 of the bill and sec. 401 of the Code)

Present Law

If a pension, profit-sharing or stock bonus plan qualifies under the tax law (sec. 401(a), 403(a), or 405(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, and (3) benefits distributed as a lump sum distribution may be accorded special treatment, or may be rolled over, tax-free, to an individual retirement account, annuity, or bond (IRA) or another qualified plan. To be qualified, a pension, profit-sharing or stock bonus plan, by its terms, must satisfy various specifically enumerated qualification requirements described in section 401(a). Under present law, a plan must comply with these qualification requirements in form as well as operation.

If the qualification provisions are changed, present law generally requires that conforming plan amendments be adopted no later than the last day of the first plan year after the effective date of the change and the amendment must be effective, for all purposes, not later than the first day of that plan year.[23]

Reasons for Change

Given the number of qualification changes made by this bill, the committee believes it is appropriate to provide an extended remedial amendment period for compliance with these changes.

Explanation of Provision

In general

Under the bill, the provisions generally apply as of the separately stated effective date (generally, years beginning after December 31, 1985). However, a plan will not fail to be a qualified plan on account of changes made in this bill for any year beginning before January 1, 1988, provided

(1) the plan complies, in operation, with the changes as of the separately stated effective date;

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[23] This "remedial amendment period" may be further extended by the Secretary of the Treasury (sec. 401(b)). Under present law, disqualifying provisions created by statutory changes (other than those made by ERISA and TEFRA) generally are not "disqualifying provisions" eligible for this extended remedial amendment period.

(2) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1987; and

(3) the amendment applies retroactively to the first day of the first plan year beginning on the separately stated effective date.

During this period a plan will not be disqualified merely because the plan, in delaying the adoption of conforming amendments, violates the requirement (1) that benefits be definitely determinable, (2) that a plan's terms be set forth in a written document, or (3) that the plan operate in accordance with its terms.

Collectively bargained plans

Under the bill, the separately stated effective dates generally are delayed for certain collectively bargained plans. A collectively bargained plan to which the delayed effective dates apply will not fail to be a qualified plan for any year beginning before the later of (1) January 1, 1988, or (2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement (determined without regard to any extension of the terms of the agreement ratified after November 6, 1985) provided three conditions are satisfied.

First, the plan must operate in compliance with the changes for the first plan year beginning after the earlier of (1) December 31, 1990, or (2) the termination of the collective bargaining agreement.

Second, plan amendments must be adopted no later than the last day of the first plan year beginning after the later of (1) December 31, 1987, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement.

Third, those amendments must be made effective as of the first day of the first plan year beginning after the later of (1) December 31, 1987, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement.

Effective Dates

This provision applies upon enactment.

2. Requirement that Collective Bargaining Agreements be Bona Fide (sec. 1138 of the bill and sec. 7701(a)(46) of the Code)

Present Law

Under present law, many of the nondiscrimination standards of the Code applicable to qualified plans apply separately to plans or programs maintained pursuant to an agreement that is found to be a collective bargaining agreement if there is evidence that retirement benefits were the subject of good faith bargaining between the employer and employee representatives. Similar exclusions are provided with respect to certain welfare benefits provided to employees. Present law provides no clear definition of a collective bargaining agreement.

Reasons for Change

The committee is aware that some promoters of tax avoidance arrangements have entered into arrangements with employers under which, superficially, the employer and its employees are represented by agents in collective bargaining. Under the arrangement, however, no good faith bargaining occurs because the bargaining agent for the employees merely acts in concert with the named bargaining agent for the employer.

In some cases, the named bargaining agent for the employees has obtained a ruling by the Internal Revenue Service that the agent is exempt from income tax because it is a labor organization. Promoters of these arrangements have, on the basis of such a determination, represented to employers that the named agent has been determined to be an employee representative within the meaning of the provisions of the Code and ERISA. Of course, it is clear that a determination with respect to an organization's status for tax exemption is not a determination with respect to whether that organization, even if tax-exempt, is an employee representative.

The committee believes that these arrangements are, in fact, designed for no material purpose other than the improper exploitation of provisions that are appropriate only for legitimate collectively bargained plans. The committee wishes to make clear that it does not regard such an arrangement as the product of good faith bargaining and that it does not consider an entity to be an employee representative merely because of its status for tax exemption or a determination by the Internal Revenue Service with respect to that status. The committee also intends that no inference should be drawn from this discussion with respect to the issue of whether such an organization can meet the requirements of the Code for tax-exempt status. The committee also intends that no inference should be drawn from this discussion as to whether the promoters of these arrangements are subject to assessable penalties for the promotion of abusive tax shelters.

Explanation of Provision

Under the bill, no agreement will be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers.

Effective Date

This provision is effective upon enactment.

3. Penalty for Overstatement of Pension Liabilities (sec. 1139 of the bill and sec. 6659A of the Code)

Present Law

Deductions for employer contributions to defined benefit pension plans

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans

funded with annuity contracts. A qualified plan may be a pension, profit-sharing, or stock bonus plan.

A qualified pension plan may be either a defined benefit pension plan or a money purchase pension plan. Under a defined benefit pension plan, benefit levels are specified under a plan formula and are not solely dependent on the balance of an account for the employee. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee.

Limits on employer deductions

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[26]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan adjusted, if applicable, by a 10-year amortization of actuarial gains and losses over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least five taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits as well as actuarial gains and losses in equal annual payments over 10 years (sec. 404(a)(1)).

Actuarial assumptions

Because an employer who maintains a qualified defined benefit pension plan is required to fund the cost of projected benefits on a level basis, it is necessary to make certain assumptions with respect to the level of benefits that actually will be provided by the plan. The assumptions necessarily take into account economic conditions and events that will occur in the future. These assumptions, particularly the assumption with respect to interest rates that will prevail in the future, can have a significant effect on estimates of the cost of a plan and on deduction limits with respect to employer contributions to plans.

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[26] Under the minimum funding standard, the normal cost of a plan for a year is required to be funded currently. (The normal cost of a plan for a year is the cost of benefits earned in that year.) Past service costs (for example, the cost of a retroactive benefit increase) and actuarial and experience gains and losses are required to be spread over a period of years. (The amortization period depends on the origin of the past service cost and on the funding method used by the plan.) Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer generally is not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

Present law requires that actuarial assumptions used in determining the funding requirements of a pension plan be reasonable in the aggregate. Under this standard, reasonableness has been tested on the basis of whether, over a period of time, the actual experience of the plan is materially and consistently different from the assumed experience. Changes in estimated liabilities resulting from changes in actuarial assumptions are taken into account under the minimum funding standard over a 30-year period. Actuarial gains and losses (the difference between estimated experience and actual experience) are taken into account over a period of 15 years.

Under present law, if the Internal Revenue Service determines that the actuarial assumptions used to calculate liabilities are unreasonable, the limit on employer deductions is recalculated using reasonable assumptions and the excess deduction is disallowed.

Valuation overstatements

Present law generally provides a penalty for certain valuation overstatements, such as an overstatement of the value of an item for which a charitable deduction is claimed (sec. 6659). The amount of the penalty is a specified percentage of the underpayment of income tax attributable to the valuation overstatement. That percentage is 10, 20, or 30 percent, depending on the degree of overstatement of the value or basis of property and on whether the overstatement occurred with respect to a charitable deduction. A similar penalty applies to underpayments of estate or gift taxes attributable to valuation understatements (sec. 6660). Neither penalty applies if the underpayment is less than $1,000. The IRS has authority to waive the penalty if the taxpayer shows a reasonable ground for the claimed valuation or basis.

These overvaluation penalties do not apply to overvaluations of employer liability under a defined benefit pension plan.

Reasons for Change

The committee is aware that, in some instances, deductions for employer contributions to defined benefit pension plans have been based on overstatements of the liabilities under the plans. For example, cases have been found in which the liability of a plan to provide benefits with respect to unmarried professionals, who were the sole owners and employees of their professional corporations, were overstated through the use of extreme actuarial assumptions. A pattern was found in which a corporation's deductions were based on the assumptions that (1) the professional employee will be married when benefits commence, (2) the spouse will be considerably younger than the employee (20 years in one case), (3) the spouse will outlive the employee, and (4) the plan will provide survivor benefits to the surviving spouse for an extended period. The committee also is aware of cases in which plans enjoying investment yield in excess of nine percent are computing deductions on the basis of a five-percent investment yield (larger contributions are required under a plan that earns a lower yield).

The committee questions the effectiveness of the present-law deduction sanction. The committee notes that, even if excessive de-

ductions are disallowed, certain deduction carryovers are permitted. Thus, even if deductions are deferred, they are not lost. The committee believes it is necessary to provide a more effective deterrent to discourage overvaluation and, thus, found it appropriate to apply a specific penalty to discourage overvaluation of pension liabilities.

Explanation of Provision

Overview

The bill provides a new penalty in the form of a graduated addition to tax applicable to certain income tax overstatements of deductions for pension liabilities. As an addition to tax, this penalty is to be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to the extent of any income tax underpayment that is attributable to such an overstatement.

The portion of a tax underpayment that is attributable to a valuation overstatement is to be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement is the excess of the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation of deductions for pension liabilities and takes into account any other proper adjustments) over (2) actual tax liability as reduced by taking into account the valuation overstatement.

The application of the valuation overstatement penalty does not preclude the application of other penalties or excise taxes against a taxpayer. For example, in an appropriate situation, the valuation overstatement penalty, as well as the five-percent negligence penalty, other penalty or penalties, or excise taxes (including the 10-percent annual excise tax on nondeductible employer contributions) might be assessed against the same taxpayer.[27]

Overstatement of pension liabilities

Under the bill, there is an overstatement of deductions for pension liabilities if the amount of the deduction for pension liabilities claimed on the employer's tax return exceeds 150 percent of the amount determined to be the correct amount of the deduction. If there is an overstatement of deductions for pension liabilities, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	*The applicable percentage is—*
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

[27] For example, if both the valuation overstatement penalty and the 10-percent excise tax (sec. 4980) apply, the valuation overstatement penalty will be applied against the portion of the tax underpayment due to the valuation overstatement and the excise tax will be applied separately against the entire amount of contributions that are determined to be nondeductible.

Exceptions and waiver provisions

As under the present-law overvaluation penalty provision, there is a de minimis exception to the new penalty. The valuation overstatement penalty does not apply if the underpayment for a taxable year attributable to the valuation overstatement is less than $1,000.

In addition, the bill grants the Treasury Department discretionary authority to waive all or part of the penalty on a showing by a taxpayer that there was a reasonable basis for the deduction claimed on the return and that the claim was made in good faith.

Definitions

For purposes of the penalty, the term "underpayment" has the same meaning as under the present-law rules relating to negligence and civil fraud penalties (sec. 6653(c)(1)) (generally, the excess of the amount of tax that should have been paid over the amount shown on the return plus any amounts previously assessed or collected).

Effective Date

The provision applies to returns filed after December 31, 1985.

Revenue Effect of Part E

The provisions are estimated to increase fiscal year budget receipts by a negligible amount.

F. Fringe Benefit Provisions

1. Nondiscrimination Rules for Certain Statutory Fringe Benefit Plans (sec. 1151 of the bill, secs. 79, 105, 106, 120, 125, 127, 129, and 7701, and new sec. 89 of the Code)

Present Law

Overview

Under present law, certain employer-provided fringe benefits are excluded from the gross income of employees if provided under certain statutorily prescribed conditions. Similar exclusions generally apply for employment tax purposes.

Among those conditions that generally apply to the exclusion of employer-provided fringe benefits is the requirement that fringe benefits be provided on a nondiscriminatory basis. Thus, with the exception of the exclusion for employer-provided health insurance, each fringe benefit exclusion is not available unless nondiscrimination rules are met that require that the benefit not be provided on a basis that favors certain categories of employee who are officers, owners, or highly compensated. Failure to satisfy the applicable nondiscrimination test results in a denial of the tax exclusion for all employees receiving the benefit or only for the employees in whose favor discrimination is prohibited, depending on the benefit.

Separate nondiscrimination rules apply with respect to each benefit. Thus, an individual in whose favor discrimination is prohibited for one benefit may or may not be such an individual for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Health benefit plans

Under present law, a nondiscrimination test is not applied as a condition of the exclusion of health benefits provided by an employer under an insured plan, and the exclusion of medical benefits and reimbursements provided under such insurance (secs. 105 and 106). However, if an employer provides its employees with health benefits under a self-insured medical reimbursement plan (sec. 105(h)), the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent that the plan does not discriminate in favor of highly compensated employees.

A self-insured health plan is discriminatory if it favors highly compensated individuals either as to eligibility to participate or as to benefits. For purposes of this nondiscrimination rule, related employers are treated as a single employer.

Under the eligibility test, a self-insured health plan must benefit (1) at least 70 percent of all employees, (2) at least 80 percent of all

eligible employees, but only if at least 70 percent of all employees are eligible to participate, or (3) a class of employees that does not discriminate in favor of highly compensated individuals. In determining whether a plan satisfies any of these tests, employees who have not completed 3 years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

The benefits provided under a self-insured health plan will be treated as discriminatory unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

For purposes of these rules, highly compensated individuals are (1) the 5 highest paid officers, (2) shareholders owning more than 10 percent of the stock of the employer, and (3) employees who are among the highest paid 25 percent of employees (excluding employees who are not participants and who may be disregarded for purposes of the eligibility test).

Group-term life insurance plans

Under present law, an exclusion is provided for the cost of group-term life insurance coverage (up to $50,000) under a plan maintained by an employer (sec. 79). If a group-term life insurance plan is determined to be discriminatory, the exclusion of the cost of $50,000 of group-term life insurance does not apply with respect to key employees. A discriminatory plan is one that discriminates in favor of key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. For purposes of these rules, related employers are treated as a single employer.

With respect to eligibility, a group-term life insurance plan must satisfy one of the following tests: (1) the plan benefits at least 70 percent of all employees; (2) at least 85 percent of all participants are not key employees; (3) the class of employees receiving benefits does not discriminate in favor of key employees; or (4) in the case of a plan that is part of a cafeteria plan, the cafeteria plan requirements are met. In determining whether a plan satisfies this eligibility test, employees who have not completed 3 years of service, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens who receive no U.S. earned income may be disregarded.

For purposes of determining whether the type or amount of benefits under the plan discriminates in favor of key employees, all benefits available to key employees must be available to all other employees. Group-term life insurance benefits will not be considered discriminatory merely because the amount of life insurance provided to employees bears a uniform relationship to compensation.

The term "key employee" is generally defined as it is under the top-heavy rules applicable to qualified pension plans: officers, the top 10 employee-owners, 5-percent owners, and one-percent owners receiving at least $150,000 in annual compensation (sec. 416(i)). Employees are key employees with respect to a year if they fall within one of the above categories at any time during the current year or any of the 4 preceding years.

Group legal services plans

The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees (sec. 120). In determining whether a plan benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, the exclusion is available only if no more than 25 percent of the amounts contributed during a year may be provided for 5-percent owners (or their spouses or dependents).

Educational assistance programs

Under present law, the amounts paid or expenses incurred (up to $5,000 a year) for an employee under an employer-provided educational assistance program are excluded from income (sec. 127). The exclusion is not available if the program benefits a class of employees that is discriminatory in favor of employees who are officers, owners, or highly compensated (or their dependents). Under this test, employees covered by a collective bargaining agreement may be disregarded. Also, the exclusion is available only if no more than 5 percent of the amounts paid or incurred by the employer for educational assistance may be provided for 5-percent owners (or their spouses or dependents).

Dependent care assistance programs

Present law provides an exclusion from income for amounts paid or incurred for an employee under a dependent care assistance program (sec. 129). The exclusion is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a program benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employers for dependent care assistance is provided for 5-percent owners (or their spouses or dependents).

Welfare benefit plans

A voluntary employees' beneficiary association or a group legal services fund that is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules (sec. 505). Under these rules, no class of benefits may be provided to a class of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment

compensation benefit will not fail the benefits test merely because the amount of benefits provided to employees bears a uniform relationship to compensation. For purposes of these rules, related employers are treated as a single employer.

For purposes of the above rules, the following employees may be disregarded: (1) employees with less than three years of service; (2) employees who have not attained age 21; (3) seasonal or less than half-time employees; (4) employees covered by a collective bargaining agreement; and (5) nonresident aliens with no U.S. earned income. Under a special rule, if a benefit, such as group legal services, is covered by a separate nondiscrimination rule, that separate rule will apply in lieu of the rules described above.

The term "highly compensated individual" includes any individual who is one of the five highest paid officers, a 10 percent shareholder, or among the highest paid 10 percent of all employees. For purposes of determining the highest paid 10 percent of all employees, employees who have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

These nondiscrimination rules also apply for certain other purposes. For example, they must be satisfied in order for an employer to be able to deduct contributions to a welfare benefit fund to provide post-retirement life insurance or health benefits. Also, post-retirement life insurance or a post-retirement health benefit provided through a welfare benefit fund will be subject to a 100 percent excise tax if the plan of which the fund is a part does not satisfy these nondiscrimination rules.

Cafeteria plans

Under a cafeteria plan, a participant is offered a choice between cash and one or more fringe benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). This cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. For purposes of these rules, related employers are treated as a single employer.

A cafeteria plan does not discriminate as to eligibility to participate if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) employees who have completed 3 years of service (or such shorter period as specified in the plan) are eligible to participate.

A cafeteria plan will not be considered to discriminate as to contributions and benefits if statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants. If a cafeteria plan provides health benefits, the plan will not be treated as

discriminatory if the following tests are met: (1) contributions on behalf of each participant include either (a) 100 percent of the cost of health benefit coverage of the majority of highly compensated participants who are similarly situated, or (b) 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage under the plan; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation. If a cafeteria plan is maintained pursuant to a collective bargaining agreement between employee representatives and 1 or more employers, the plan is deemed to be nondiscriminatory.

A participant or individual is considered highly compensated for purposes of the cafeteria plan rules if that individual is an officer, a 5-percent shareholder, highly compensated, or a spouse or dependent of any of the above.

In addition, under a cafeteria plan, no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees. Related employers are treated as a single employer for purposes of this rule. The term "key employee" has the meaning given to such term for purposes of the top-heavy rules applicable to qualified retirement plans (i.e., officers, the top 10 employee-owners, 5-percent owners, and one-percent owners with at least $150,000 in compensation).

Reasons for Change

Under present law, the tax-favored treatment of employer-provided fringe benefits reduces the Federal income tax base and contributes to higher marginal tax rates on wages, dividends, rents, and all other income not exempt from tax. These costs may be justified only if employer-provided fringe benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who otherwise would not purchase or could not afford such coverage. The committee believes that strict nondiscrimination rules are a necessary adjunct to this public policy rationale because they permit the exclusions of fringe benefits only if the benefits are provided to a broad cross-section of employees. Nontaxable fringe benefits that favor key or highly compensated employees do not serve public policy objectives, but are instead a form of tax-preferred compensation for a limited class of employees.

The committee further believes that the excludable fringe benefit that creates the largest tax expenditure (i.e., health insurance) and is considered the most significant fringe benefit in terms of its importance to employees should be subject to nondiscrimination rules. As with other fringe benefits, the exclusion of such insurance from employees' income should be conditioned on its nondiscriminatory provision to a broad cross-section of employees. In addition, the nondiscrimination rules that currently apply to fringe benefits are inconsistent and fail to establish clear and administrable standards. The separate nondiscrimination rules applicable to each fringe benefit employ different definitions and establish different standards for nondiscriminatory coverage. These differences create

unnecessary complexity for taxpayers and for the Internal Revenue Service.

The committee concludes that the present-law nondiscrimination rules create gaps in coverage because many of the rules permit an employer to select a narrow class of employees who are covered under the employer's plan and also permit employers to exclude from coverage employees who have not completed three years of service with the employer. The committee believes that these rules do not adequately accomplish the goal of expanded coverage.

Also, the current nondiscrimination rules provide inadequate guidance to taxpayers and to the Internal Revenue Service. The definition of prohibited group members is generally vague, leaving unclear, for example, who qualifies as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members.

Therefore, the committee believes that the present-law nondiscrimination rules should be modified to expand coverage and to provide consistent and uniform principles for all fringe benefit exclusions. As a general rule, the committee believes that, to the extent possible, the nondiscrimination rules should require employers to cover substantial percentages of employees, rather than selective classes of employees.

The committee recognizes that employers desire flexibility in designing fringe benefit programs. However, the committee believes the need for flexibility is justified only under certain limited circumstances. For example, if an employer operates, for legitimate economic reasons, multiple lines of business, the fringe benefit structures in each line of business may differ because of historical trends within each industry. The committee bill permits employers to test the nondiscrimination rules separately with respect to each line of business. The committee is concerned, however, that the line of business exception not be administered in a manner that circumvents the committee's basic premise that highly compensated employees should not be permitted to exclude fringe benefits unless the employer's plan benefits substantial percentages of the employer's employees.

Explanation of Provisions

Overview

The bill establishes comprehensive nondiscrimination rules for statutory fringe benefit plans, welfare benefit plans, and cafeteria plans (sec. 89). Under the bill, a highly compensated employee who is a participant in any discriminatory statutory fringe benefit plan is taxed on the value of such employee's employer-provided benefit under the plan.

The bill establishes three general nondiscrimination rules: (1) a uniform nondiscriminatory eligibility rule applicable to all statutory fringe benefit plans, (2) a nondiscriminatory benefits test applicable to insurance-type statutory fringe benefit plans, and (3) a nondiscriminatory benefits test applicable to all other statutory fringe benefit plans. The bill extends to welfare benefit funds nondiscrimination rules similar to those applicable to statutory fringe

benefit plans. The bill modifies the nondiscrimination rules applicable to cafeteria plans under present law, and the rules governing the year in which benefits under a discriminatory cafeteria plan must be included in income by highly compensated and key employees.

Finally, the bill extends to all statutory fringe benefits reporting requirements with respect to fringe benefits that are includible in income and requires that Treasury conduct a study of abuses of the health insurance provisions.

General rule for inclusion

In general

Under the bill, a highly compensated employee who is a participant in a discriminatory statutory fringe benefit plan is required to include in income an amount equal to the employee's employer-provided benefit under the plan.

The bill also provides that the gross income of any employee, whether or not highly compensated, includes such employee's employer-provided benefit under a statutory fringe benefit plan, unless (a) the plan is in writing; (b) the employees' rights under the plan are legally enforceable; and (c) the employer established the plan with the intention of maintaining it indefinitely.

Statutory fringe benefit plan

Under the bill, "statutory fringe benefit plans" include employer-maintained group-term life insurance plans, accident or health benefit plans (whether self-insured or funded through an insurance company), qualified group legal services plans (whether self-insured or funded through an insurance company), educational assistance programs, and dependent care assistance programs. With respect to disability coverage the committee intends that only coverage attributable to employer contributions (including elective contributions) that provides disability benefits that are excludable from income under section 105(b) or (c) of the Code is subject to the nondiscrimination rules applicable generally to statutory fringe benefit plans.

Highly compensated employee

For purposes of the new nondiscrimination rules applicable to statutory fringe benefit plans, the term "highly compensated employee" generally has the same meaning as in the provisions of the bill relating to qualified cash or deferred arrangements, with a few exceptions. Under the bill, as in the case of a cash or deferred arrangement, an employee is treated as highly compensated with respect to a year if, at any time during the year or any of the two preceding years, the employee (1) is a five-percent owner of the employer (as defined in sec. 416(i)); (2) earns over $50,000 in annual compensation from the employer; or (3) is a member of the top-paid group of the employer.

Under the bill, the top-paid group includes all employees who (1) are in the top 10 percent of all employees on the basis of compensation, and (2) earn more than $20,000 a year. However, an employee is not included in the top-paid group if the employee earns less

than $35,000 and is not in the top 5 percent of all employees on the basis of compensation.

The bill provides that an employee will not be treated as in the top-paid group or as earning in excess of $50,000 during the current year unless the employee is a member of the group consisting of the 100 employees who have earned the highest compensation from the employer during such year.

With respect to plans other than insurance-type plans, the treatment of family members of highly compensated employees is similar to that provided for under qualified cash or deferred arrangements. If, during the year in which the determination is being made, an employee benefits under the plan and is a family member of (1) one of the top 10 highly compensated employees by compensation, or (2) a 5-percent owner, benefits received by the family member are treated as received by the highly compensated employee for purposes of the nondiscrimination rule, and the family member and the highly compensated employee are treated as a single employee.

However, in the case of an insurance-type statutory fringe benefit plan, any member of the family of a highly compensated employee is simply treated as a highly compensated employee, if such family member is covered by the plan. In the case of all statutory fringe benefit plans, an individual is considered a family member, if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant of the employee or spouse of a lineal ascendant or descendant of the employee.

Further, the bill provides that, in determining whether an employee is a highly compensated employee, employees excluded for purposes of the nondiscriminatory coverage test (such as employees covered under a collective bargaining agreement) are not taken into account except to the extent provided in regulations.

In addition, under all statutory fringe benefit plans, a former employee is to be treated as a highly compensated employee if such employee was highly compensated at the time of separation from service or at any time after attaining age 55.

Employee's employer-provided benefit

In the case of an insurance-type plan, the bill defines the employee's employer-provided benefit as the value of the coverage provided during the taxable year to or on behalf of such employee, to the extent attributable to contributions made by the employer. In the case of any other plan, an employee's employer-provided benefit is defined under the bill as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer.

In the case of a cafeteria plan, an employee's elective contributions are treated as employer contributions for purposes of determining the value of the employee's employer-provided benefit.

The committee intends that the Secretary of the Treasury will prescribe regulations that provide guidance in determining the value of insurance coverage and of noninsurance benefits. The Secretary may establish safe-harbor methods of valuing the coverage or benefits. For example, in determining the value of discriminatory health care coverage, the Secretary may provide that in appro-

priate circumstances, the value of coverage provided under a plan to any employee may be determined by reference to average employer cost per employee covered under the plan.

The Secretary may, in prescribing such regulations, provide adjustments to the safe harbors to take account of factors relevant to the determination of the value of a benefit. For example, if an employer's accident and health plan covers employees in more than one geographic location and health care costs in such geographic locations are significantly different, then the Secretary may provide that adjustments will be made to the value of coverage to take account of such differences.

Insurance-type plans

Insurance-type plans are defined under the bill as employer-maintained plans that provide accident or health benefits, group-term life insurance benefits, and group legal benefits.

Other plans

The bill treats all other statutory fringe benefit plans as not being insurance-type plans, regardless of whether the benefits under such plans are funded by insurance.

Employer

Under certain circumstances, related employers are treated as a single employer for purposes of the nondiscrimination requirements (sec. 414(b), (c), and (m)). In addition, leased employees are treated for purposes of the nondiscrimination rules as employees of the person or organization for whom they perform services (sec. 414(n)). The bill provides that the Secretary's general regulatory authority to prevent abuse of employee benefit requirements shall apply (sec. 414(o)).

Nondiscriminatory eligibility requirement

In general

The bill establishes a uniform nondiscriminatory eligibility rule for all statutory fringe benefit plans. A plan satisfies the new eligibility rule if (a) at least 90 percent of all employees are eligible to participate in the plan; and (b) the plan contains no provisions relating to eligibility to participate that discriminate in favor of highly compensated employees.

Excluded employees

The bill generally provides that certain classes of employees may be disregarded in applying the 90 percent eligibility test if the plan, or any other plan providing similar benefits, does not benefit any employee in such class. The classes of excludable employees are (1) employees who have not completed at least 180 days of service (or such shorter period of service as may be specified in the plan, or in any other plan maintained by the employer providing similar benefits); (2) employees who normally work less than 20 hours per week (or such lesser amount as may be specified in the plan, or in any other plan maintained by the employer providing similar benefits); (3) employees who normally work less than 1,000

hours during any year (or such lesser amount as may be specified in the plan, or in any other plan maintained by the employer providing similar benefits); and (4) employees under age 21 (or such lower age as may be specified in the plan or in any other plan maintained by the employer providing similar benefits). In addition, employees covered by a bona fide collective bargaining agreement may be disregarded if the plan does not benefit any such employee. Finally, nonresident aliens who receive no United States earned income may be disregarded, regardless of whether any such individuals are covered by the plan.

The committee intends that Treasury regulations will provide a limited exception to the rule that employees who otherwise are excludable as employees who do not normally work 1,000 hours a year or 180 days may not be disregarded if any plan of the employer does not exclude such employees. The limited exception will be available if (1) substantially all employees of the employer (other than supplemental employees) generally are eligible to participate in an accident or health plan (or other fringe benefit plan) within 30 days after the date of hire, (2) the employer also employs supplemental employees who generally do not work more than 1,000 hours or more than 180 days, (3) the supplemental employees generally are not rehired if they have previously been supplemental employees, and (4) the supplemental employees do not exceed 15 percent of the employer's workforce.

Under this limited exception, supplemental employees who are (1) retired employees of the employer who are covered under an accident and health plan of the employer maintained for retirees or (2) students hired by the employer under a work-study program, may be disregarded in determining whether the employer's fringe benefit plans satisfy the nondiscrimination requirements. Of course, this limited exception would not be available if any supplemental employees are eligible to participate in any fringe benefit plan of the employer (other than a plan maintained for retired employees).

Line of business

The bill provides an exception to the general eligibility rule if the employer, for bona fide business reasons, operates a separate line of business or separate operating unit. In that event, the requirements of the general eligibility rule may be satisfied separately with respect to employees in each separate line of business or operating unit.

The bill provides certain mechanical rules to ensure proper use of the line of business or operating unit exception. An employer may not separately apply the nondiscrimination rule to any line of business or operating unit unless (1) there are at least 100 nonexcluded employees employed by the line of business or operating unit; and (2) at least 5 percent, but no more than 25 percent, of the employees in the line of business or operating unit are highly compensated. In addition, the bill provides that if employees of more than one line of business or operating unit are eligible to participate in the same plan, such lines of business or operating units are treated as a single line of business or operating unit for purposes of the nondiscriminatory eligibility requirement.

The Secretary is authorized to prescribe by regulation what constitutes a line of business or operating unit. It is the intent of the committee that the line of business or operating unit concept not be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) could not be considered a separate line of business or operating unit. Similarly, the headquarters (or home office) of an employer would not be considered a separate line of business or operating unit. Instead, it is generally intended that a line of business or operating unit include all employees necessary for preparation of certain classes of property or service for sale to customers. Certain exceptions to this rule may be established by regulation where one employer has two operations which are vertically integrated and which are traditionally operated by unrelated entities.

Nondiscriminatory benefits; insurance-type plans

The bill establishes a uniform nondiscriminatory benefits rule for all benefits provided under insurance-type plans. An insurance-type plan generally satisfies the nondiscriminatory benefits test if the insurance-type coverage provided under the plan is the same for all employees covered by such plan. A limited exception to this benefits test is provided with respect to accident or health plans for employees who normally work less than 30 hours per week. The benefits test may be considered satisfied with respect to such employees even if their employer subsidy is proportionately reduced.

The committee intends that, for purposes of this rule, the proportionate reduction in the employer subsidy could not exceed (1) with respect to employees who normally work at least 25 hours (but less than 30 hours), 75 percent of the employer subsidy for employees who normally work at least 30 hours a week, and, (2) with respect to employees who normally work less than 25 hours, 50 percent of such employer subsidy.

For example, assume that the annual cost of a health plan for an employee is $1,200. Assume further that the required employee contribution is normally $200, making the employer subsidy $1,000. The employer subsidy for an employee who normally works 25 hours per week may be reduced by 25 percent to $750 and the employee may be required to contribute $450. The subsidy for an employee who normally works less than 25 hours per week may be reduced by 50 percent to $500 and the employee may be required to contribute $700.

In the case of a cafeteria plan, an employee's elective contributions under the plan are not taken into account in determining the employer subsidy.

In the case of an accident or health plan, the bill provides that the plan will not be treated as meeting the nondiscriminatory benefits test if (a) 25 percent or more of the employees benefiting under the plan are highly compensated employees, and (b) less than 75 percent of the employees eligible to participate in the plan actually benefit under the plan.

For purposes of satisfying the nondiscriminatory benefits test, an accident or health plan may be combined with one or more plans providing the same type of benefit, if the average employer cost (including elective contributions in a cafeteria plan) per covered em-

ployee in such other plan or plans is at least 80 percent of the average employer cost (including elective contributions in a cafeteria plan) per covered employee in the plan that would otherwise fail the nondiscrimination test, if tested separately. If plans are combined for this purpose, such plans are treated as a single plan for all purposes, except for the requirement that the coverage provided under a single plan be exactly the same for all participants.

The amount of benefits provided under an employer-maintained health plan may be integrated (in a manner that does not discriminate in favor of highly compensated employees) with benefits provided under Medicare or other Federal, State, or foreign law, or under any other health plan covering the employee or a member of the employee's family.

In the case of any insurance-type plan other than a health or accident plan, the plan will be treated as not meeting the requirements of the nondiscriminatory benefits test if less than 75 percent of the employees eligible to participate in the plan actually benefit under the plan.

With respect to group-term life insurance benefits, the bill does not change the present-law rule that benefits are treated as nondiscriminatory if the amount of insurance coverage provided to plan participants bears a uniform relationship to compensation.

As noted above, under the bill, disability coverage attributable to employer contributions (including elective contributions) is subject to the nondiscrimination rules only to the extent that benefits provided under such coverage are eligible for exclusion from income under section 105 (b) or (c) of the Code. Coverage for such disability benefits is tested under the same nondiscriminatory benefits rules as those applicable to other health benefits coverage.

Nondiscriminatory benefits test; other plans

In the case of any statutory fringe benefit plan that is not an insurance-type plan, the plan meets the nondiscriminatory benefits requirement if (a) all benefits available under the plan to any highly compensated employee are available on the same terms and conditions to all other employees eligible to participate in the plan; and (b) the average benefit provided on behalf of nonhighly compensated employees equals or exceeds 80 percent of the average benefit provided to or on behalf of highly compensated employees.

Under the bill, the average benefit provided to employees other than highly compensated employees is an amount equal to the aggregate value of the benefits provided (including benefits attributable to elective contributions) under the plan to or on behalf of all nonhighly compensated employees divided by the number of nonhighly compensated employees eligible to participate in the plan during the plan year. The average benefit provided to highly compensated employees is determined by the same method.

In determining the average benefit, the bill provides a special family member rule. The rule affects only individuals who are family members of either (1) a highly compensated employee who is among the 10 employees paid the greatest compensation during the year, or (2) a five-percent owner. Any benefits received by such family member are treated as received by the highly compensated employee or five-percent owner, as the case may be, and for pur-

poses of determining the number of employees eligible to participate, the family member is disregarded.

Definition of a plan

Separate plans

For purposes of both the nondiscriminatory eligibility test and the nondiscriminatory benefit tests, each option or different benefit offered under a statutory fringe benefit plan is treated as a separate plan. This means, for example, that if two types of insurance coverage vary in any way (including the amount of the employee contribution), they will be considered separate plans. Thus, in the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan under both the nondiscriminatory eligibility test and the applicable nondiscriminatory benefits test.

Under a special rule for an accident and health plan, an employee who receives coverage both for himself and any member of his family is to be treated as having received two separate coverages: individual coverage with respect to himself, and family coverage with respect to his family. Each coverage must be tested separately under the nondiscriminatory eligibility and the nondiscriminatory benefits test. However, in determining whether a separate "family coverage health plan" is nondiscriminatory under the benefits test, the bill permits an employer to elect to take into account only employees with spouses or dependents. Alternatively, the employer may elect to apply the requirement that no more than 25 percent of the participants in a health benefit plan be highly compensated by substituting "35 percent" for "25 percent."

In the case of noninsurance-type plans, the bill requires that if a highly compensated employee benefits under two or more educational assistance programs, all such plans under which such employee benefits shall be treated as one plan for purposes of applying the eligibility and benefits tests. The same rule applies to dependent care assistance programs. For purposes of satisfying the nondiscriminatory eligibility and benefits tests, the bill permits an employer to elect to treat as one plan any two or more educational assistance programs. The same rule applies to dependent care assistance programs.

Single plan

Two or more plans that are identical in all respects, except for the group of employees covered, may be treated as a single plan. The committee intends that for purposes of determining what constitutes a single plan, two exceptions are provided to the rule that insurance coverage (or available noninsurance benefits) be identical. The first exception is that variations may be disregarded if the coverage varies in a purely mechanical manner that clearly favors those with less compensation, as in the case where the same health insurance is available on the same terms to employees, but the required employee contribution increases in proportion to compensation. The second exception is based on the bill provision that allows the employer to reduce the employer subsidy for employees who

normally work less than 30 hours per week. Under this provision, if the same health insurance is available on the same terms to employees, except that the employer subsidy is proportionately reduced for employees who normally work less than 30 hours per week, such health insurance is considered a single plan.

Measure of amount included in employee's income

The committee intends that, for purposes of taxing the highly compensated employees on discriminatory benefits (other than group term life insurance), the benefits may be considered to be provided under more than one plan so that highly compensated employees are only taxed on the discriminatory excess.

Where two or more plans are aggregated under either the mandatory or permissive aggregation rules for plans other than insurance plans, the plans are not treated as one plan for purposes of determining the amount, if any, included in the income of any highly compensated employee participant. In other words, the discriminatory excess may be treated as a separate plan.

Former employees

The committee intends that rules similar to the eligibility and benefits tests shall be applied separately to former employees. In applying the eligibility test to former employees, the Secretary is to prescribe regulations under which certain special rules shall apply. Employers may generally restrict the class of former employees to be tested to those who have retired on or after a reasonable retirement age, or to those who separated from service due to disability. In addition, employers may generally limit the class further to employees who have, for example, retired within a certain number of years. Finally, in testing whatever class of employees is chosen under the eligibility test, employers may make reasonable assumptions regarding mortality, so that they do not have to determine those former employees who are still alive.

Cafeteria plans

Nondiscrimination standards

The bill modifies the present-law general nondiscrimination test applicable to cafeteria plans (sec. 125(b)(1)), but preserves the present-law concentration test applicable to such plans (sec. 125(b)(2)). Under the bill, a cafeteria plan is subject to the nondiscriminatory eligibility test applicable to all statutory fringe benefit plans. Also, the bill provides that all benefits available under a cafeteria plan to any highly compensated employee are to be available on the same terms and conditions to all other employees eligible to participate under the plan.

Year of inclusion in income

The bill repeals the present-law rule that, in the case of a cafeteria plan that does not satisfy the relevant nondiscrimination rules or concentration test, benefits under the plan are taxed to highly compensated employees or key employees in the taxable year of the employee in which the plan year in which the benefit was provided ends, rather than in the year in which the taxable benefit not

elected under the cafeteria plan would otherwise be includible in income. Thus, under the bill, an individual is taxed under the general principles of constructive receipt.

Welfare benefit funds

The bill extends to welfare benefit funds rules similar to the new nondiscriminatory eligibility and benefits tests applicable to statutory fringe benefits.

Reporting requirements

The bill expands the present law requirement that the employers that maintain cafeteria plans, educational assistance programs and group legal services plans file an annual information return in accordance with Treasury regulations. The bill requires that, if benefits provided under a cafeteria plan or statutory fringe benefit plan are includible in the income of a highly compensated or key employee, the employer is required to file an information return, pursuant to regulations to be provided by the Treasury, setting forth the amount of the benefit and the name and address of the employee in whose income the benefit is includible. The employer is also required to furnish to each such employee a written statement showing the amount of the fringe benefits includible in the employee's income.

Study

The bill requires that the Treasury Department conduct a study of abuses in the health insurance area and make recommendations for changes in the nondiscrimination rules. Not later than July 1, 1986, Treasury is required to report the results of the study, together with any recommendations it deems advisable, to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation of Congress. The bill authorizes the Secretary to collect data necessary to complete the study.

Effective Date

The provisions are effective for years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by a negligible amount in 1986, $71 million in 1987, $125 million in 1988, $138 million in 1989, and $151 million in 1990.

2. Two-Year Extension of Exclusions for Educational Assistance Programs and Group Legal Plans (sec. 1161 of the bill and secs. 120 and 127 of the Code)

Present Law

Educational assistance

Under section 127 of the Code, an employee's gross income for income and employment tax purposes does not include amounts

paid for expenses incurred by the employer for educational assistance to the employee if such amounts are paid or such expenses are incurred pursuant to an educational assistance program that meets certain requirements specified in that section. In the absence of the exclusion contained in section 127, an employee would be required to include the value of educational assistance provided by the employer to the employee, unless the cost of such assistance would qualify as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible employee business expenses if the education (1) maintains or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of employment.

Under present law, the maximum amount of educational assistance benefits that an employee can receive tax-free during any taxable year is limited to $5,000 so that the excess benefits over this amount is subject to income and employment taxes. In the case of an employee who works for more than one employer, the $5,000 cap applies to the aggregate amount of educational assistance benefits received from all employers.

Amounts expended for education that may be deducted by the employee as an employee business expense are not subject to the $5,000 cap on educational assistance benefits and are not counted in determining whether other educational benefits received during the year exceed the cap.

Any employer maintaining a section 127 educational assistance plan during any year is required to file an information return with respect to the program at the time and in the manner required by Treasury regulations. The return must show (1) the number of employees of the employer, (2) the number of employees eligible to participate in the program (3) the number of employees participating under the program, (4) the total cost of the plan during the year, and (5) the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged.

In 1984, the Congress directed the Treasury Department to conduct a study of the effect of the exclusion for employer-provided educational assistance. A copy of the report, together with any recommendations by Treasury, was to be submitted to the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate not later than October 1, 1985.

The exclusion for educational assistance benefits is scheduled to expire for taxable years beginning after December 31, 1985.

Group legal services

Under present law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) are excluded from an employee's gross income for income and employment tax purposes (sec 120). The exclusion also applies to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee (or the employee's spouse or dependents). In order to be a qualified plan under which employees are entitled to tax-free benefits, a group legal services plan must fulfill several

requirements with regard to its provisions, the employer, and the covered employees. An employer maintaining a group legal services plan is required to file an information return with respect to the program at the time and in the manner required by Treasury regulations.

The exclusion for group legal services benefits is scheduled to expire for taxable years ending after December 31, 1985.

Reasons for Change

The exclusions for educational assistance and group legal services were originally enacted in 1978 for a temporary period in order to provide Congress with an opportunity to evaluate the use and effectiveness of the exclusions. However, the absence of any information reporting prior to 1985 made it difficult to obtain information concerning the operation of the exclusions. The information for 1985 has not yet been filed.

The committee recognizes that the Treasury Department is currently conducting a comprehensive examination of the effect of the exclusions for educational assistance and group legal services on the income, wage, and benefit bases. The committee believes that it is appropriate to extend the educational assistance and group legal services exclusion for an additional two years to permit Treasury to complete its evaluation of the effect of these exclusions based on the information reports that employers are now required to file.

Explanation of Provision

The bill extends the educational assistance and group legal services exclusions for two years. Thus, these exclusions are scheduled to expire for taxable years beginning after December 31, 1987 and ending after December 31, 1987, respectively.

Effective Date

The provisions are effective upon enactment.

Revenue Effect

The provisions are estimated to decrease fiscal year budget receipts by $117 million in 1986, $181 million in 1987, and $60 million in 1988.

3. Treatment of Certain Full-time Life Insurance Salespersons (sec. 1162 of the bill and sec. 7701(a) of the Code)

Present Law

Under a cafeteria plan, an employee is offered a choice between cash and one or more fringe benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes.

Under present law, a full-time life insurance salesperson is treated as an employee for purposes of eligibility for certain enumerated fringe benefit exclusions (sec. 7701(a)(20)). However, although such

a salesperson is eligible to receive certain excludable fringe benefits, the salesperson is not treated as an employee who is eligible to participate in athe cafeteria plan provisions to the extent the salesperson is otherwise permitted to exclude from income the benefit elected.

Reasons for Change

The committee believes it is inconsistent to treat full-time life insurance salespersons as employees for certain fringe benefit exclusions, yet limit the ability of such salespersons to elect to receive the same benefits under the cafeteria plan.

Explanation of Provision

The bill permits a full-time life insurance salesperson to be treated as an employee for purposes of the cafeteria plan provisions to the extent the salesperson is otherwise permitted to exclude from income the benefit elected.

Effective Date

The provision applies for years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by a negligible amount.

G. Changes Relating to Employee Stock Ownership Plans

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan which may be utilized as a technique of corporate finance and under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Gain realized on the sale of employer securities to an ESOP is generally taxed at capital gain rates.

1. Changes in Requirements Relating to Employee Stock Ownership Plans (sec. 1173 of the bill and secs. 401, 404, 409, and 4975 of the Code)

Present Law

Overview

Under present law, a funded pension, profit-sharing or stock bonus plan (including an ESOP) is a qualified plan if it meets certain requirements of the Internal Revenue Code. A trust forming part of a qualified plan is exempt from tax as a qualified trust if (1) employer contributions to the trust are made for the purpose of distributing the corpus and income to employees and their beneficiaries, and (2) under the trust instruments, it is impossible for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees before the liabilities to employees and their beneficiaries are satisfied. Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated.

A qualified plan (including an ESOP) is required to meet minimum standards relating to coverage (the class of employees eligible to participate in the plan) (sec. 410), vesting (the time at which an employee's benefit becomes nonforfeitable) (sec. 411(a)), and benefit accrual (the rate at which an employee earns a benefit) (sec. 411(b)). Also, minimum funding standards apply to the rate at which employer contributions are required to be made in order to ensure the solvency of pension plans (sec. 412). Further, contributions or benefits must not exceed specified limits (sec. 415).

In addition to satisfying these general requirements, applicable to all qualified plans (sec. 401), ESOPs generally must satisfy special qualification requirements (sec. 409).[28] The scope of these spe-

[28] Certain tax-credit ESOPs established pursuant to section 301(d) of the Tax Reduction Act of 1975 (TRASOPs) could, but were not required to, meet the general plan qualification requirements.

cial qualification rules differs depending on whether the plan is structured as a tax-credit ESOP. A tax-credit ESOP is an ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability.

Vesting

In general

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, the Employee Retirement Income Security Act of 1974 (ERISA) and the Code generally require that: (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) that a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service.

In addition, for any plan year for which a plan is top heavy,[29] an employee's right to accrued benefits must become nonforfeitable under one of two alternative schedules. A plan satisfies the first alternative vesting schedule (three-year, full vesting) if a participant who has completed at least three years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions. The second alternative requires 20-percent vesting after completion of two years of service and an additional 20-percent vesting for each additional year of service until 100-percent vesting is attained after six years of service.

Special ESOP rules

Under the special qualification rules for tax-credit ESOPs, a participant's right to employer securities allocated to an account under a tax-credit ESOP must be nonforfeitable at all times.

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[29] A top-heavy plan is one under which no more than 60 percent of the benefits are provided for key employees (sec. 416).

Nondiscrimination rules

In general

Present law provides nondiscrimination standards for qualified plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated (sec. 410(b)). In addition, contributions or benefits provided under a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 401(a)(4)).

For any year for which a plan is a top-heavy plan, present law provides that only the first $200,000 of compensation may be taken into account under the plan for purposes of applying these nondiscrimination tests. Present law further provides that, beginning in 1988, this $200,000 limit will be adjusted to reflect post-1986 cost-of-living increases. However, effective for years beginning after 1985, the bill reduces the limit on includible compensation from $200,000 to an amount equal to seven times the defined contribution plan dollar limit ($175,000 for 1986) and applies the limit to all plans, whether or not top-heavy. See discussion of the Adjustments to Limitations on Contributions and Benefits Under Qualified Plans.

Special ESOP rules

Under the special qualification rules for tax-credit ESOPs, any employee participating in the plan and entitled to share in the allocation of employer securities must receive an allocation of securities based upon the ratio of that participant's compensation to all compensation paid to participants. However, only the first $100,000 of compensation may be taken into account in determining this allocation.

Investment in employer securities and voting rights

In general

ERISA generally provides a limit on the proportion of plan assets that may be invested in securities or real property of a related employer. Under ERISA, in the case of a defined benefit pension plan or a money purchase pension plan, holdings of qualifying employer securities and qualifying employer real property generally may not exceed 10 percent of plan assets (ERISA sec. 407(a)). Certain defined contribution plans may hold up to 100 percent of plan assets in qualifying employer securities and qualifying employer real property provided the plan specifies the extent of such investments.

Special ESOP rules

An ESOP must be designed to invest primarily in qualifying securities of the employer. An ESOP will not be a qualified plan unless, in addition to satisfying the usual qualification requirements, it provides that (1) participants have the right to demand that benefits be distributed in the form of employer stock; (2) participants have a right to require that the employer repurchase the securities under a fair valuation formula (i.e., a "put option") if the employer securities are not readily tradable; and (3) participants

have the right to direct the trustee to vote certain employer securities.

Definition of employer securities

In the case of an ESOP, employer securities are defined as common stock or certain convertible preferred stock[30] issued by the employer maintaining the ESOP (or by a corporation that is a member of the same controlled group)[31] that is readily tradable on an established securities market (sec. 409(h)(1)).

If there is no readily tradable common stock issued by the employer (or any member of a controlled group including the employer), employer securities are qualifying employer securities only if they consist of that common stock issued by the employer (or any member of a controlled group including the employer) having (1) voting power at least equal to that class of common stock having the greatest voting power, and (2) dividend rights at least equal to that class of common stock having the greatest dividend rights (sec. 409(l)(2)).

Voting rights

An ESOP maintained by an employer that has registration-type[32] securities must provide that each participant in the plan is entitled to direct the trustee in the exercise of voting rights with respect to securities allocated to the participant's account (sec. 409(e)(2)).

In addition, a tax-qualified defined contribution plan (other than a profit-sharing plan) that is established by an employer whose securities are not publicly traded and that, following any acquisition of employer securities after 1979, holds more than 10 percent of its assets in employer securities, must provide that a plan participant is entitled to direct the trustee in the exercise of voting rights with respect to employer securities allocated to the participant's account on any corporate issue that must, by law or charter, be decided by more than a majority vote of outstanding common shares voted on the issue (sec. 401(a)(22)).

Timing and form of distributions

In general

Unless an employee otherwise elects in writing, the payment of benefits from a qualified plan generally must begin no later than 60 days after the end of the plan year in which the employee attains the normal retirement age under the plan (or age 65, if earlier). The payment of benefits may be deferred beyond normal retirement age (or age 65, but not beyond the required beginning date) if

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[30] Noncallable preferred stock that is convertible at any time into otherwise qualifying employer securities may be treated as qualifying employer securities.

[31] Although a group of corporations that is a controlled group within the meaning of sec. 1563 generally will be considered a controlled group for purposes of identifying which securities are qualifying employer securities, a series of special rules also applies with respect to certain tiered subsidiaries.

[32] Registration-type securities are defined as (1) those required to be registered under section 12 of the Securities Exchange Act of 1934, and (2) those that would be required to be registered but for the exemption provided by section 12(g)(2)(H) (relating to securities issued in connection with a qualified stock bonus, pension, profit-sharing, or annuity plan).

the employee has not yet separated from the employer's service or has not yet completed 10 years of plan participation (sec. 401(a)(14)).

Benefits under a qualified stock bonus plan must be distributable in the form of employer securities.

Special ESOP rules

A participant in a leveraged ESOP or a tax credit ESOP who is entitled to a distribution under the plan must be provided the right to demand that the distribution be made in the form of employer securities rather than in cash. Alternatively, subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest partly in cash and partly in employer securities.

In addition, a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable.[33]

The distributee must be given at least sixty days after receipt of the securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option, the option will temporarily lapse. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities (in accordance with Treasury regulations) as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. The distributee must then be given at least sixty days to require that the employer repurchase the employer securities. If the distributee does not exercise this put option, the option permanently lapses.

If the put is exercised, present law requires that the provision for payment by the employer be reasonable. If payment of the put option price is deferred, the deferral is considered reasonable only if (1) the employer provides adequate security and a reasonable rate of interest, and (2) the cumulative amount actually paid is not less, at any time, than the aggregate amount of reasonable periodic payments that, but for the deferral, would have been made. Reasonable periodic deferrals are defined as substantially level annual installments commencing within 30 days after the date on which the put option is exercised and generally ending not more than 5 years after the date of exercise. However, the deferral period may be extended to a date no later than the earlier of (1) 10 years from

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[33] Present law provides certain exceptions to these rules requiring distributions of employer securities. First, an ESOP may preclude a participant from demanding a distribution in the form of employer securities if the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. The ESOP must, however, provide that participants entitled to a distribution have a right to receive the distribution in cash.In addition, in the case of a tax credit ESOP or a leveraged ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception is made to the rule generally requiring that a participant who receives a distribution of employer securities must be given a put option if the securities are not readily tradable. No put option is required if the ESOP provides that participants entitled to a distribution from the plan have a right to receive the distribution in cash.

the date the put option is exercised or (2) the date the securities acquisition loan with which the securities were acquired is repaid.

Reasons for Change

The committee is concerned that the present-law rules encouraging ESOPs provide tax benefits to employers and others engaged in ESOP transactions without ensuring increased rights of ownership for participating employees. In particular, the committee is concerned about the extent to which disproportionate amounts of employer securities are allocated to highly compensated employees, whether participants have the right to vote employer securities, and the rate at which employees' interests under an ESOP become nonforfeitable. Accordingly, the committee believes it is appropriate to tighten the nondiscrimination rules, to expand the pass-through voting requirements, and to require accelerated vesting.

In addition, the committee is concerned that employees for whom an ESOP provides a major source of retirement savings may be disadvantaged due to the fact that those savings may be invested exclusively in employer securities. To minimize that concern, the committee found it appropriate to require ESOPs to allow certain plan participants approaching retirement age to elect partial diversification of their ESOP account balance.

Explanation of Provisions

Overview

Under the bill, additional qualification requirements (sec. 401(a)(27)) are provided for any ESOP (within the meaning of section 4975(e)(7)). These additional qualification requirements (1) require more rapid (10-year graded) vesting; (2) modify the ESOP nondiscrimination rules to limit (a) the amount of a participant's compensation that may be taken into account and (b) the annual amount of employer contributions that may be allocated to employees who are officers, shareholders or highly compensated; (3) expand the pass-through voting requirements applicable to employer securities held by an ESOP; (4) permit an eligible plan participant to direct the ESOP trustee to diversify a portion of the participant's ESOP account balance; and (5) modify the distribution and put option requirements.

Vesting

Under the provision, any ESOP that is not top heavy is required to provide that a participant's right to the accrued benefit derived from employer contributions must become nonforfeitable no more slowly than under a special 10-year graded vesting schedule. The special vesting schedule requires 20-percent vesting after completion of six years of service and an additional 20-percent vesting each year until 100-percent vesting is attained after 10 years of service. An ESOP must provide that all plan benefits vest no more slowly than pursuant to this 10-year graded vesting schedule or, if applicable, pursuant to one of the two alternative top-heavy plan vesting schedules (sec. 416). No exception is provided for class year plans.

For purposes of determining service under this 10-year graded vesting schedule of the bill, the present-law rules (sec. 411) relating to years of service, breaks in service, and permitted forfeitures, are to apply. Accordingly, except to the extent inconsistent with this special rule, all years of service with the employer generally are to be taken into account, including years of service completed prior to the enactment of the bill.

Nondiscrimination rules

The bill modifies the general nondiscrimination rules by limiting the amount of employer contributions that may be provided for employees who are officers, shareholders, or highly compensated (sec. 401(a)(27)(B)).

Under the bill, no more than one-third of the employer's contributions for a year may be allocated to the group of employees consisting of officers, 10-percent shareholders or highly compensated individuals. For purposes of this provision, an individual is a 10-percent shareholder if he or she owns, directly or indirectly, more than 10 percent of the total combined voting power of all classes of stock entitled to vote or more than 10 percent of the total value of shares of all classes of stock (other than stock held by qualified plans). An individual is considered highly compensated if the individual's compensation exceeds an amount equal to 200 percent of the dollar limit on annual additions to a defined contribution plan (i.e., for 1985, 200 percent of $30,000, or $60,000).

Voting rights

The bill also modifies the pass-through voting rights applicable to ESOPs maintained by employers that do not have registration-type securities. If the employer does not have registration-type securities, then (1) participants with fewer than 10 years of service must have the right to direct the trustee to vote allocated securities with respect to any corporate matter that, by law or charter, must be decided by more than a majority vote, and (2) participants with 10 or more years of service must have the right to direct the trustee to vote allocated securities on all issues (sec. 409(e)(3)). As under present law, no pass-through of voting rights is required with respect to unallocated securities.

In addition, the bill retains the present law requirements applicable to employers with registration-type securities. Thus, if an employer has registration-type securities, participants must have the right to direct the trustee how to vote allocated securities on all issues.

Diversification of investments

In general

The bill requires an ESOP to offer a partial diversification election to participants who meet certain age and participation requirements (qualified employees). Under the bill, a qualified employee must be entitled annually during any diversification election period occurring within the employee's qualified election period direct diversification of up to 25 percent of the participant's account balance (50 percent after attainment of age 60). To the

extent that a participant elects to diversify a portion of the account balance, the bill requires an ESOP to offer at least three investment options not inconsistent with regulations prescribed by the Secretary and to complete the diversification within a specified period.

Under the bill, distribution to the participant within 90 days after the close of the annual diversification election period of an amount not to exceed the maximum amount for which a participant elected diversification is deemed to satisfy the diversification requirement.

Qualified election period; qualified employees

Each ESOP must provide an annual diversification election period for the 90-day period following the close of the ESOP plan year. Thus, within 90 days after the end of a plan year, an ESOP must permit an election by those qualified employees who become or remain eligible to make a diversification election during the plan year. Under the bill, any employee who has attained at least age 55 and completed at least 10 years of participation in the ESOP is a qualified employee. Any qualified employee is permitted to make a diversification election during any diversification election period occurring within that employee's qualified election period.

A qualified employee's qualified election period generally begins with the plan year following the plan year during which the qualified employee attains age 55 and ends with the fifth succeeding plan year. If, however, the employee has not completed 10 years of participation in the ESOP by the end of the plan year in which the employee attains age 55, the qualified election period begins with the plan year following the year in which he completes 10 years of participation and ends with the plan year following the year in which he attains age 60.

For example, in the case of an ESOP using the calendar year as the plan year, a participant who completes 10 years of participation before attaining age 55 and who attains age 55 in 1990, becomes a qualified employee in the 90-day election period beginning January 1, 1991. That participant will remain eligible to direct diversification during the annual election periods in 1992, 1993, 1994, 1995 and 1996.

Amount eligible for diversification

Under the bill, for any participant who has attained age 55 (but not age 60) and completed 10 years of participation in the plan, the amount of a participant's account balance subject to the diversification election at the end of the plan year is 25 percent of the participant's account balance at the end of the year reduced by amounts previously diversified. For any participant who has attained age 60 and completed 10 years of participation, the amount eligible for diversification at the end of the plan year is 50 percent of the participant's account balance at the end of the year, minus amounts previously diversified. Because these rules permit diversification not to exceed a cumulative amount, the scope of each year's election depends, in part, on prior elections.

The committee intends the Secretary of the Treasury to issue regulations providing that no separate diversification election be

provided for de minimis amounts. In addition, in no event will amounts previously diversified be required to be reinvested in employer securities due to decreases in the value of the account balance.

These rules are illustrated by the following example:

Assume a participant with 10 years of participation in an ESOP attains age 55 during the 1986 plan year and that the ESOP uses a calendar plan year. During the 90-day period beginning on January 1, 1987, and ending on March 31, 1987, the participant may direct the trustee to diversify up to 25 percent of the participant's account balance. If the participant elects to direct diversification of the maximum amount—25 percent—the only amounts for which the participant may elect diversification during the 1988, 1989, 1990, and 1991 election periods are amounts attributable to increases in the participant's account balance, whether attributable to growth or additional employer contributions. However, pursuant to regulations to be issued by the Secretary of the Treasury, no diversification election is required for de minimis amounts.

From January 1, 1992 to March 31, 1992, the participant must be given the opportunity to direct diversification of up to 33-1/3 percent of the remaining account balance (bringing the total amount subject to the diversification election to a cumulative 50 percent of the participant's account balance at the end of the 1991 plan year). Whether or not this participant directed diversification in 1992, no further diversification election is required to be provided to the participant.

Alternatively, if the participant did not elect diversification during the 1987 election period, a similar election would be available during the 1988, 1989, 1990, and 1991 election periods. In each year, the participant could elect to direct diversification with respect to that portion of the account balance that, when aggregated with prior amounts for which diversification was elected, did not exceed 25 percent of the account balance at the end of that year.

If the participant did not elect diversification during the 1987-1991 election periods, a final election would be available in 1992 (i.e., the first election period following the plan year in which the participant attains age 60) to direct diversification of up to 50 percent of the participant's account balance.

Implementation of diversification

No later than 90 days after the close of the election period, the plan trustee(s) must complete diversification pursuant to participant elections. The trustee(s) may satisfy this requirement (1) by distributing to the participant an amount equal to the amount for which the participant elected diversification, or (2) by substituting for the amount of the employer securities for which the participant elects diversification, an equivalent amount of other assets, in accordance with the participant's investment direction. The ESOP must offer at least three investment options (not inconsistent with regulations prescribed by the Secretary) that may, but need not, include an option to permit full self-direction.

Whether or not the trustees must actually sell employer securities to satisfy the diversification elections depends, in part, on the extent to which the ESOP is invested in employer securities. Pro-

vided the amount of total trust assets invested in other than employer securities is greater than the total amount for which diversification is elected, it may be possible to complete diversification (without disposing of employer securities) by allocating alternative assets to electing participants' accounts or by disposing of such alternative assets and reinvesting the proceeds in the investments directed by participants.

In addition, under the bill, a participant who receives a distribution of securities in satisfaction of a diversification election is permitted to roll over the distribution into another qualified plan or IRA.

Distribution and put option requirements

Timing of distribution

The bill also modifies the rules relating to the timing and form of required distributions.

Under the bill, an ESOP must permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits from an ESOP must begin no later than 60 days after the end of the plan year in which occurs (1) the second anniversary of the date on which the participant separates from service, or (2) the first anniversary of the date on which the securities acquisition loan was repaid, if later.

These rules are illustrated by the following examples:

Example 1.—Assume that an ESOP uses a calendar year plan year. Assume further that a participant separated from service at age 35 on June 30, 1986, when the ESOP had fully repaid the securities acquisition loan. Unless the participant otherwise elected, in writing, to defer commencement of benefits, the bill generally requires that benefits commence no later than March 1, 1989, 60 days after the close of the 1988 plan year (in which the second anniversary of the participant's separation from service occurred).

Example 2.—Assume the same facts as Example 1, except the ESOP had a securities acquisition loan that was finally repaid on June 1, 1989. Unless the participant otherwise elects in writing to defer commencement, the bill generally requires that benefits commence no later than March 1, 1991. This is the later of 60 days after the close of the 1988 plan year (in which occurred the 2nd anniversary of the date on which the participant separated from service) or the 1990 plan year (in which occurred the first anniversary of the plan year in which the securities acquisition loan was repaid).

The rules added by the bill are intended as an acceleration of the otherwise applicable benefit commencement date. Accordingly, if the general rules (sec. 401(a)(14)) would require the commencement of distributions at an earlier date, those general rules would override this special ESOP rule.

Thus, for example, if the participant in Example 1 had attained age 65 and completed 10 years of participation prior to separation on June 30, 1986, benefits must commence, as under present law, no later than 60 days after the close of the 1986 plan year (i.e., the plan year in which the separation occurred).

Form of distribution

The bill generally retains the present-law requirements that a participant in an ESOP who is entitled to a distribution under the plan must be provided the right to demand that the distribution be made in the form of employer securities rather than in cash and the present-law requirement that a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable. However, the bill modifies the permissible periods over which the employer may pay the option price to the participant.

Put option period

Under the bill, each distributee (including those participants eligible for accelerated distribution upon separation from service under the provisions of the bill) must be given at least 60 days after receipt of the employer securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option, the option will temporarily lapse. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination (in accordance with Treasury regulations) of the value of the employer securities as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. The distributee must then be given at least 60 days to require that the employer repurchase the employer securities. If the distributee does not exercise this put option, the option permanently lapses.

Payments of the put-option price

Under the bill, the present-law rules that permit an employer to make payments of the option price over extended periods are modified. The modifications contained in the bill apply with respect to all ESOP distributions, not merely the accelerated distributions added by the bill.

Lump sum distributions

For a participant who received a lump sum distribution of employer securities from an ESOP and exercised the put option (either in the year of the distribution or the following year), the employer must pay the option price to the participant no later than 30 days after the close of the 60-day option period.

Alternatively, certain deferred payments may be made over a period beginning on the date 30 days after the close of the 60-day option period and extending for no more than five years. Unlike present law, the deferral period may not be extended to 10 years or the date the securities acquisition loan is repaid. As under present law, deferred payments will be permitted only if (1) the employer provides adequate security and a reasonable rate of interest, and (2) the entire amount is paid in substantially equal payments over the scheduled payment period.

Other distributions

For a participant who received a distribution of employer securities from an ESOP (other than a lump sum distribution), and elected to exercise the put option, the employer must pay the full amount of the option price to the participant no later than 90 days after the close of the 60-day option period. No deferred payments are permitted.

The determination as to whether the 5-year deferred payment period or the 90-day deferred payment period will apply is based upon the character of the original distribution. Thus, for example, if a participant who receives a lump sum distribution exercises the put option only with respect to a portion of the securities received, the employer may make payments over a period not to exceed 5 years.

Independent appraiser

Under the bill, the valuation of employer securities contributed to or purchased by an ESOP must be determined by an independent appraiser (within the meaning of section 170(a)(1)). The appraiser's name must be reported to the Internal Revenue Service.

Effective Dates

These additional qualification requirements generally apply to ESOPs adopted after December 31, 1985. In addition, for ESOPs in existence prior to January 1, 1986, these requirements apply to amounts contributed after December 31, 1985 (or securities purchased with those amounts). Thus, an ESOP in existence on December 31, 1985, to which no additional contributions are made after that date need not be amended to comply with these requirements. However, to the extent that additional contributions are made after December 31, 1985, the ESOP would be required to comply with these additional qualification requirements.

2. Repeal of Employee Stock Ownership Credit (secs. 1171 and 1174 of the bill and secs. 38, 41, 401, 404 409 and 6699 of the Code)

Overview

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. A tax credit ESOP must satisfy additional special requirements relating to vesting, allocation of employer contributions, and certain distribution rules.

Limits on tax credits

Special tax credits are provided for employers maintaining qualifying tax credit ESOPs. These credits were initially investment based (and the plans were called TRASOPs) but, generally effective after 1982, are payroll based (and the plans are called PAYSOPs).

For taxable years ending after December 31, 1982, in lieu of the additional investment tax credit, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all em-

ployees under the plan. For compensation paid or accrued in calendar years 1983 through 1987, the tax credit is limited to one-half of one percent of compensation. No tax credit is permitted for compensation paid or accrued in calendar years beginning after 1987.

No payroll-based tax credit is allowed for contributions to a plan if more than one-third of the employer's contribution for the year is allocated to the group of employees consisting of officers, 10-percent shareholders or individuals whose compensation exceeds a specified limit (for 1985, $60,000) (sec. 41(c)(1)(A)). A 10-percent shareholder means a shareholder who, directly or indirectly, owns more than 10 percent of the total outstanding voting power of all classes of employer stock (other than stock held by a qualified plan).

The amount of the employer's income tax liability that can be offset by the payroll-based tax credit for contributions to a tax credit ESOP generally is limited to the first $25,000 of tax liability, plus 85 percent of the excess over $25,000 (sec. 38(c)).[34] If the tax credit exceeds the amount of tax liability against which the credit may be applied for a taxable year, certain carrybacks and carryforwards are provided.[35]

Distribution restrictions

Stock bonus plans

In general, a qualified stock bonus plan may distribute amounts attributable to employer contributions only after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of an event such as a layoff, illness, disability, retirement, death, or separation from service. Amounts that are to be distributed after a fixed number of years must be held in trust for at least two years. Special rules further restrict distributions from a stock bonus plan that contains a cash or deferred arrangement. An ESOP that is structured as a stock bonus plan is subject to these restrictions.

Qualified money purchase plans

A qualified money purchase pension plan may not distribute benefits before (1) the employee retires or otherwise separates from service, (2) the employee becomes disabled or dies, or (3) the plan terminates. The money purchase pension plan portion of an ESOP that is structured as a combination of a stock bonus plan and money purchase pension plan is subject to these restrictions.

Special tax credit ESOP restrictions

In addition to satisfying general qualified plan requirements with respect to plan distributions, a tax credit ESOP must further restrict distributions. In general, employer securities allocated to an employee's account under a tax credit ESOP may not be distrib-

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[34] If the employer is a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied is reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations (sec. 38(c)(3)(B)).

[35] The unused tax credit may be carried back to each of the three preceding taxable years and carried forward to each of the 15 succeeding taxable years (sec. 39(a)). The amount of any unused credit that expires at the close of the last taxable year to which it may be carried is allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for employer contributions to qualified plans (sec. 404(i)).

uted before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability. In addition, the 84-month rule does not apply in the case of the direct or indirect transfer of a participant from the employment of a selling corporation to the employment of an acquiring employer where all (or substantially all) of the assets used by the selling corporation in a trade or business are sold to the acquiring employer. The 84-month rule is also waived for an employee of a subsidiary of the selling corporation, with respect to securities of the selling corporation, where the selling corporation disposes of its interest in the subsidiary and the employee continues in the employ of the subsidiary.

Reasons for Change

The committee is interested in retaining tax incentives for Employer Stock Ownership Plans (ESOPs). However, in evaluating the relative tax benefits provided for ESOPs, the committee concluded that other incentives (including the financing incentives added by the Deficit Reduction Act of 1984 (DEFRA) are more important than the special ESOP tax credits. Thus, in order to raise sufficient revenue to retain the incentives added by DEFRA, the committee believes it is appropriate to repeal the special ESOP tax credits.

Explanation of Provision

The bill repeals the special ESOP tax credit for years after 1985. Thus, under the bill, no tax credit is provided for compensation paid or accrued after December 31, 1985. Of course, credits to which an employer became entitled prior to January 1, 1985, are not affected by this provision.

In addition, the bill amends the tax credit ESOP distribution provisions to permit certain distributions upon plan termination. Thus, the 84-month rule generally will not apply with respect to distributions made on account of the termination of a tax-credit ESOP. Under the bill, distributions eligible to be made upon plan termination must consist of the entire balance to the credit of the participant.

Effective Dates

The repeal of the payroll-based tax credit generally applies with respect to compensation paid or accrued after December 31, 1985. Special rules are provided for certain ESOPs.

The provision permitting distributions upon plan termination generally is effective for termination distributions made after December 31, 1984. The provision limiting qualifying termination distributions to total distributions, however, applies for distributions made on account of terminations occurring after December 31, 1985.

3. Termination of Certain Additional Tax Benefits Relating To Employee Stock Ownership Plans (secs. 1172 and 1175 of the bill and secs. 133, 404, 1042, 2210 and 4978 of the Code)

Present Law

Deduction for dividends paid on ESOP stock

As amended by the Deficit Reduction Act of 1984 (DEFRA), effective for dividends paid in taxable years beginning after December 31, 1984, present law permits an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP), but only to the extent the dividends are actually paid out currently to participants or beneficiaries (sec. 404(k)).

An employer is allowed a deduction for its taxable year in which the dividends are paid to participants. The deduction is allowed with respect to dividends that (1) are, in accordance with the plan provisions, paid in cash directly to the participants, or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116.

Partial exclusion of interest earned on ESOP loans

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan (sec. 133) made after July 18, 1984, and used to acquire employer securities after such date.

A securities acquisition loan is defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(1)) for the plan.

Tax deferred rollover on gain derived from sales of stock to an ESOP

As amended by DEFRA, effective for sales in taxable years of the seller beginning after July 18, 1984, present law permits a taxpayer to elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in certain qualified replacement property within a replacement period (sec. 1042). To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP; (2) the ESOP or cooperative must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the ESOP or cooperative must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

In general, the basis of the taxpayer in qualified replacement property is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the ESOP that was not recognized pursuant to the election provided by this provision. The gain is to be recognized upon disposition of the qualified replacement property.

Payment of estate tax liability by an ESOP

As amended by DEFRA, effective for the estates of decedents required to file estate tax returns on a date after July 18, 1984, present law provides special rules permitting an ESOP to assume certain estate tax liabilities. If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor of the decedent's estate generally is relieved of estate tax liability to the extent the ESOP or cooperative is required to pay the liability (sec. 2210).

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate otherwise is eligible to make deferred payments of estate taxes pursuant to section 6166[36] with respect to the decedent's interest in qualified employer securities; and (2) the executor elects to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative also may elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section. The usual rules relating to deferred estate tax payments (sec. 6166) apply to determine ongoing eligibility for deferral.

Reasons for Change

The committee is interested in retaining certain of the many tax benefits provided for ESOPs. In choosing among the various benefits, the committee stressed the need to retain, if possible, in a revenue neutral fashion, those incentives needed to ensure the adoption of ESOPs. In attempting to evaluate the various incentives, however, the committee concluded that it is too soon to judge the effectiveness of the special financing incentives added by DEFRA. Though interested in continuing the incentives, at least for a period long enough to judge their effectiveness in promoting employee ownership, the committee is also aware of the cost of retaining these incentives and the need for revenue neutrality. Thus, the committee believes that it is appropriate to repeal the special ESOP tax credits to pay for an extension of the DEFRA incentives.

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[36] An election under section 6166 permits a qualifying estate to pay estate taxes in installments for up to 14 years (annual interest payments for four years, followed by up to 10 annual installments of principal and interest. In addition, a special four-percent interest rate applies to estate taxes on the first $1 million of value of an interest in a closely held business.

However, the committee is aware that mere repeal of the credits does not generate sufficient revenue to permit long term retention of the incentives. Accordingly, the committee concluded that it is appropriate to sunset those incentives after three years, at which time the committee will reevaluate the provisions.

Explanation of Provisions

The bill generally repeals the special tax incentives for ESOP financing at the end of 1988.

In addition, the bill provides a special rule for eligible worker-owner cooperatives to ensure that such organizations can comply with the requirements of section 1042 and 2210.

Effective Dates

Under the bill, the repeal of the dividends paid deduction is effective for dividends paid after December 31, 1988, on employer securities allocated to participants' accounts under an ESOP.

The repeal of the 50 percent interest exclusion for interest earned on certain securities acquisition loans is generally effective for securities acquisition loans made after December 31, 1988. With respect to securities acquisition loans made prior to January 1, 1989, a bank, insurance company, or commercial lender may continue to exclude 50 percent of the interest income received.

The repeal of the provision permitting deferred recognition of gain realized on certain sales to an ESOP or eligible worker-owned cooperative is effective for sales made after December 31, 1988. With respect to sales made before January 1, 1989, for which the seller elected to defer recognition, the present law provisions requiring that the ESOP hold the securities for at least 3 years (including the excise tax on early dispositions) and the provisions requiring recognition of the seller's gain upon disposition will continue to apply.

The repeal of the provision permitting an ESOP or eligible worker-owned cooperative to assume estate tax liability for certain employer securities transferred from a decedent is effective with respect to decedents dying after December 31, 1988.

Revenue Effect of ESOP Provisions

The provisions are estimated to increase fiscal year budget receipts by $1,062 million in 1986, $2,117 million in 1987, $1,371 million in 1988, $706 milion in 1989, and $547 million in 1990.

TITLE XII—UNEARNED INCOME OF MINOR CHILDREN; TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS

A. Unearned Income of Certain Children (sec. 1201 of the bill and sec. 1 of the Code)

Present Law

In general

The Federal income tax liability of a minor child having gross income generally is computed in the same manner as that of an adult. Thus, a minor child is allowed a personal exemption ($1,040 for 1985) and the applicable zero bracket amount (ZBA) ($2,390 for a single person for 1985).

Dependency exemption

In general.—Under present law, a taxpayer is allowed a dependency exemption ($1,040 for 1985) for each individual who qualifies as a dependent. Individuals eligible to be claimed as dependents generally include certain family members whose gross income is less than the personal exemption allowance and for whom the taxpayer provided more than half the support.

Special rules for children.—In general, a person with gross income in excess of the personal exemption allowance ($1,040 for 1985) may not be claimed as a dependent on another taxpayer's return, even though the taxpayer satisfies the general support requirement by furnishing over half of the dependent's support for the year. However, parents may claim a full dependency exemption ($1,040 for 1985) for their dependent child with income in excess of that limit if the child (1) is under age 19, or (2) is a full-time student. Thus, two personal exemptions (for 1985, $1,040 each) are available with respect to a minor child—one on the parents' return and one on the child's return.

Zero bracket amount

Special rules apply for calculating the zero bracket amount (ZBA) of a child eligible to be claimed as a dependent on the parents' return. Although both the parents and the child are entitled to claim a full personal exemption for the child, the child may apply the ZBA only against earned income, if any. Thus, in effect, a child's unearned income (such as dividends and interest) in excess of the personal exemption is fully taxable to the child at the child's marginal tax rate.

Reasons for Change

The committee believes that the present law rules governing the taxation of minor children provide inappropriate tax incentives to shift income-producing assets among family members. In particular, the committee is aware that the treatment of a child as a separate taxpayer encourages parents whose income would otherwise be taxed at a high marginal rate bracket to transfer income-producing property to a child to ensure that the income is taxed at the child's lower marginal rates. The provision of duplicate personal exemptions with respect to the child provides an additional incentive for these intra-family transfers because income not in excess of the child's personal exemption ($1,040 for 1985) is completely excluded from tax as a result of the transfer.

The committee also believes that the increased personal exemption otherwise provided by the bill should not be available to minor children who are eligible to be claimed as dependents. Increasing the child's personal exemption allowance would provide increased incentives for intra-family transfers of income-producing property by effectively sheltering up to $2,000 of income on a tax-free basis. The policy justifications for increasing the personal exemption—the desire to minimize the tax burden on low-income taxpayers—do not apply to children who are supported by their parents and who have significant income-producing assets. The committee concluded that it is appropriate to provide a $1,000 personal exemption for minor children.

Explanation of Provision

Overview

To the extent unearned income derived from property transferred from the parents (parental-source unearned income) exceeds the amount of the child's personal exemption, the bill taxes such income to the child at the parents' marginal tax rate (sec. 1).

However, earned income and nonparental-source unearned income (i.e., income derived from property that is a qualified segregated asset) is taxed to the child at the child's marginal tax rates.

Property eligible to be treated as a qualified segregated asset includes earned income, money or property received from someone other than a parent or stepparent, and property received by reason of the death of a parent. No other amounts received directly or indirectly from a parent or stepparent may be treated as qualified segregated assets.

Definition of a minor child

Under the bill, the special rules for taxation of a minor child's parental-source unearned income at the parent's marginal rate bracket apply to any child who has not attained 14 years of age before the close of the taxable year and who has at least one living parent.

Children who have attained age 14 are taxed as separate taxpayers. However, limitations on the personal exemption and standard deduction apply to such a child who is eligible to be claimed as a dependent by a parent.

Calculation of income taxable at the parents' marginal rate

Under the bill, the tax imposed on an eligible minor child is not less than the sum of (1) the tax that would be imposed on income other than net parental-source unearned income, determined under the child's separate rate structure, and (2) a tax on the net parental-source unearned income, determined at the parents' marginal rate.

"Parental-source unearned income" means that portion of gross income that is not earned income (within the meaning of section 911(d)(2)) and is not income derived from a qualified segregated asset. All unearned income of a child is treated as parental-source unearned income unless the income is derived from a qualified segregated asset. Net parental-source unearned income is the excess of parental-source unearned income over deductions allowed for the taxable year that are directly connected with the production of such income. The taxpayer may apply up to $1,000 of the personal exemption against net parental-source unearned income. In no event, however, shall the amount of the net parental-source unearned income for any taxable year exceed the child's total taxable income for such taxable year. Thus, no tax will be imposed on the parental-source unearned income of such a child if the earned income of the child does not exceed the standard deduction and the unearned income of the child does not exceed $1,000.

Qualified segregated assets

Under the bill, the term "qualified segregated asset" includes any asset entirely attributable to nonparental sources (or income from such asset) if the asset is timely identified as a qualified segregated asset.

An asset generally is considered to be derived from nonparental sources provided it has not been received, directly or indirectly, by the child from any parent or stepparent of the child. Income derived from property received from a parent or stepparent is, for purposes of this rule, treated as property received from a parent or stepparent. However, under the bill, property received by reason of the death of a parent or stepparent is considered to be derived from nonparental sources.

For purposes of this rule the term "parent or stepparent" includes any parent as well as any individual who is or was a stepparent.

An asset will not be considered a qualified segregated asset unless it is identified as a qualified segregated asset no later than the due date (calculated with extensions) for the child's tax return for the taxable year in which the child acquired the asset, or, if later, the due date (calculated with extensions) for the first tax return that the child is required to file. Assets acquired before the effective date of this provision must be identified as qualified segregated assets no later than the due date (calculated with extensions) for the child's first tax return that is required to be filed for a taxable year beginning after December 31, 1985.

Assets are to be identified as qualified segregated assets in such manner as the Secretary of the Treasury shall prescribe.

Parent's marginal rate

For purposes of this provision, the term "parent's marginal rate" means (1) with respect to so much of the net parental-source unearned income as does not exceed the unused tax bracket amount allocated to the child, the rate applicable to that bracket or brackets, and (2) with respect to taxable income in excess of that allocated tax-bracket amount, 38 percent.

Under the bill, either parent may make an annual election to allocate any unused tax bracket amounts for that year to any child who has not attained age 14. For example, if the parents file a joint return and have income of $60,000 for a year, then, under the rates included in the bill, there is $40,000 of unused tax bracket in the 35-percent marginal bracket. Under the bill, the parents can allocate that $40,000 of 35-percent bracket among their children under age 14 (and, if appropriate, any trusts created by either parent; *see* discussion of the income taxation of trusts and estates). If the parents allocated all of the $40,000 to one child, the tax on that child's net parental-source unearned income is computed by taxing the first $40,000 of such income at 35 percent and the balance of such income at 38 percent.

Under the bill, the parent or parents will make the allocation as provided in regulations to be promulgated by the Secretary of the Treasury. Any child who does not receive notification of any unused bracket allocation computes tax on the child's net parental-source unearned income using a 38-percent tax rate.

Once the parents have elected to allocate unused tax brackets for a taxable year to one or more of their children who are under age 14, that election is irrevocable. Thus, the tax liability of the parents and children for the election year are computed as if they were subject to tax rate schedules consistent with that election. Thus, in the example above, if the parents subsequently were determined to have more taxable income (by audit or otherwise), that income would be taxed at 38 percent—as if the 35-percent bracket stopped for them at $60,000 of income. Thus, the taxes of eligible minor children to whom the parents had allocated unused bracket amounts will not be affected by adjustments to the parents' taxable income. Similarly, adjustments to the childrens' income do not affect the taxation of the parents.

Effective Date

The provision generally applies for taxable years beginning after December 31, 1985. Thus, the net parental-source unearned income of a child attributable to transfers of property by parents before 1986 will be subject to tax at the marginal rate of the parents for taxable years of the child beginning after December 31, 1985. Such income includes income from transfers in trust made by a parent before September 25, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $97 million in 1986, $292 million in 1987, $300 million in 1988, $330 million in 1989, and $363 million in 1990.

B. Income Taxation of Trusts and Estates (sec. 1211 of the bill and secs. 641-44, 651-52, 661-64 and new secs. 645-46, 653, 665-66, and new Chapter 99 of the Code)

Present Law

In general

Under present law, trusts and estates generally are treated as conduits with respect to amounts that are distributed currently and taxed as individuals with respect to amounts retained in the trust or estate. The conduit treatment is achieved by allowing the trust or estate a deduction for amounts that are distributed to beneficiaries during the taxable year to the extent of the distributable net income of the trust or estate for that taxable year. Such distributions are includible in the gross income of the beneficiaries to the extent of the distributable net income of the trust or estate. In general, the character in the hands of the beneficiary of amounts distributed by a trust or estate is the same as it was in the hands of the trust or estate.

When a trust distributes previously accumulated income to a beneficiary, the tax on that distribution is determined by a special averaging rule. Under that rule (called the "accumulation distribution" or "throwback" rule), that income is taxed at the average of the top tax rates of the beneficiary during three of the previous five years, excluding the highest and lowest years.

In addition, where the grantor transfers property to a trust and retains certain powers or interests over the trust, the grantor is treated as the owner of that trust for Federal income tax purposes under the so-called "grantor trust provisions" and the income and deductions attributable to that trust are included directly in the grantor's taxable income. In addition, a beneficiary is treated as the owner of a trust where the beneficiary has given up a power to revoke the trust but retains any of such powers or interests in the trust.

Deductions, exemptions, etc.

Trusts and estates generally are entitled to the same deductions to which an individual is entitled. Trusts and estates are not entitled to the credit for political contributions.

Estates are entitled to a deduction, in lieu of a personal exemption, of $600. Trusts which are required to distribute all of their income currently are entitled to a deduction of $300. All other trusts are entitled to a deduction of $100.

Both trusts and estates are allowed an unlimited deduction for amounts of gross income which are paid pursuant to the terms of the governing instrument to charitable organizations unless the trust or estate has unrelated business taxable income. In addition, estates are entitled to an unlimited deduction for amounts of gross income which are irrevocably set aside pursuant to the terms of the governing instrument for charitable purposes.[1] The amount of

[1] Trusts created before October 9, 1969 (or are created pursuant to certain wills drafted before October 9, 1969) also are allowed a set-aside charitable deduction.

the charitable deduction from capital gains is adjusted to reflect any capital gains deductions allowed to the trust or estate.

Depreciation, depletion, and certain amortization deductions are allocated between the entity and the beneficiaries based on either the allocation provided in the trust instrument or the allocation of trust (or estate) income between the trust (or estate) and its beneficiaries.

At the termination of an estate or trust, the beneficiaries are entitled to use any of the trust's or estate's unused net operating loss carryovers, capital loss carryovers, or operating losses incurred in the last taxable year of the trust or estate.

Trusts and estates generally are taxed at the same rates as a married person filing a separate return. In the case of gain derived from the sale or exchange of property held by the trust for two years or less, that portion of the gain attributable to the difference between the fair market value of the property and the grantor's basis in the property at the time it was contributed to the trust is taxed at the grantor's marginal tax rates.

Distributable net income

The concept of distributable net income serves three functions under present law: first, it limits the amount of the deduction that the trust or estate can take for distributions to beneficiaries; second, it determines the amount of distributions to beneficiaries that must be included in the gross income of the beneficiaries; and, third, it acts as a means of retaining the character of the various classes of income that are distributed to beneficiaries.

Distributable net income is determined by making several adjustments to the taxable income of the trust or estate. First, the amount of taxable income is increased by (1) all distribution deductions, (2) the deductions allowed of the trust or estate in lieu of the personal exemption, (3) tax-exempt interest, (4) and any excluded interest or dividends. Second, the amount of taxable income is then reduced by certain capital gains, and in the case of simple trusts, stock dividends and extraordinary dividends, which are not distributed to beneficiaries. Finally, additional modifications are required in the case of foreign trusts.

In determining the character of the items included in distributable net income, deductions are first allocated to income to which they directly relate. Remaining expenses may then be allocated to any type of income of the trust or estate, provided that a proportionate amount is allocated to any tax-exempt interest earned by the trust or estate.

Nongrantor trusts

Trusts (other than so-called "grantor trusts") and estates are taxed as individuals, except that the trust or estate generally is allowed a deduction for amounts paid to its beneficiaries. There is a separate set of rules for simple trusts and complex trusts. These separate sets of rules generally provide comparable treatment for simple and complex trusts, except that the rules applicable to complex trusts are more comprehensive to take account of the more difficult factual patterns existing in the case of complex trusts.

Simple trusts

A simple trust is a trust that is (1) required to distribute all of its income (as determined for State law purposes) currently, (2) has no charitable beneficiaries for the taxable year, and (3) makes no distributions of corpus during that year.

A simple trust is entitled to a deduction for the income that is required to be distributed currently, whether or not actually distributed during the taxable year during which the income is received. However, the deduction cannot exceed the distributable net income of the trust for that year reduced by any amounts included in distributable net income that are not includible in gross income.

Beneficiaries of a simple trust must include in their gross income all amounts of income that are required to be distributed that year, regardless of whether and when the required distributions are actually made. Nonetheless, the amount includible in the income of beneficiaries cannot exceed the distributable net income of the trust or estate. Where the amount of the required distributions exceeds the amount of the distributable net income, then each beneficiary is deemed to receive a proportionate share of the distributable net income. The character of the amounts includible in the gross income of the beneficiaries is the same as the character of those items to the trust or estate. Unless the trust instrument allocates different classes of income to different beneficiaries, each beneficiary is deemed to receive a proportionate amount of each class of income includible in the distributable net income of the trust.

Where the trust and the beneficiaries have different taxable years, the amounts includible in the gross income of the beneficiaries are determined by reference to income of the trust for its taxable year ending with or within the taxable year of the beneficiary.

Complex trusts and estates

The complex trust rules apply to all trusts that are not simple trusts and all estates. Thus, the complex trust rules apply, for example, if there are distributions of corpus during the year, if the trust has any charitable beneficiaries for the taxable year, if any part of the income of the trust is not distributable that year, or if the trustee has discretion as to whether or not to distribute income that year.

Under the complex trust rules, the trust or estate is allowed a deduction for amounts of income that are required to be distributed that year (whether or not actually distributed during that taxable year) and for all other amounts that are properly paid, credited, or required to be distributed for that taxable year. As in the case of simple trusts, the deduction is limited to the distributable net income of the trust or estate computed by excluding any items that are not includible in the gross income of the trust or estate.

The taxation of the beneficiaries of complex trusts or estates depends upon their classification under a so-called "tier system." Under the tier system, the distributable net income of the trust or estate is first allocated to the beneficiaries to whom amounts of income are required to be distributed (i.e., the so-called "first tier beneficiaries"). For the purpose of computing the amount of distrib-

utable net income allocable to first tier beneficiaries, the distributable net income is computed without taking into account any charitable deduction of the trust or estate. Any remaining distributable net income is then allocated to all other amounts paid to beneficiaries (i.e., the so-called "second tier beneficiaries"). For the purpose of determining the distributable net income allocable to second tier beneficiaries, the distributable net income is computed by deducting any allowable charitable deductions.[2] The character of amounts of distributable net income includible in the gross income of the beneficiaries of a trust or estate is the same as the character of the amounts of distributable net income in the hands of the trust or estate. Unless the governing instrument specifically allocates different classes of income to different beneficiaries, each beneficiary is deemed to receive a proportionate amount of each class of income includible in the distributable net income of the trust or estate.

Special rules for complex trusts

Present law provides a number of special rules that apply to complex trusts and estates, but not to simple trusts.

First, the rules that deem the first amounts distributed to consist of distributable net income do not apply to a gift or bequest of a specific sum of money or specific property that is not paid in more than three installments.

Second, the rules that deem the first amounts distributed to consist of distributable net income do not apply to amounts transferred or set-aside for charitable purposes.

Third, a distribution deduction is not allowed for distributions of amounts that previously had been deducted.

Fourth, at the election of the trustee, amounts distributed by a trust (but not an estate) within the first 65 days after the close of a taxable year may be treated as distributed on the last date of the preceding taxable year.

Finally, the distributable net income of a trust (but not an estate) with more than one beneficiary which has substantially separate and independent shares is allocated among those beneficiaries as if the beneficiaries were beneficiaries of different trusts.

Accumulation distributions

Special rules (referred to as the so-called "accumulation distribution" or "throwback" rules) apply to the taxation of beneficiaries of a trust (but not an estate) where the trust distributes amounts of income (other than capital gain) that had previously been taxed to the trust. Under these rules, the income is first increased (grossed up) by the taxes previously paid by the trust on the distributed income. The grossed-up income is then included in the gross income of the beneficiary. A tax is then computed on the grossed-up amount by using the average top marginal rate of the beneficiary during three of the five preceding taxable years, excluding the

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[2] The net effect of disallowing the charitable deduction for purposes of computing the distributable net income of first tier beneficiaries but allowing the charitable deduction for purposes of computing the distributable net income of second tier beneficiaries is to allocate the income of the trust or estate first to first tier beneficiaries, then to charitable beneficiaries, and finally to the second tier beneficiaries.

two taxable years with the highest and lowest incomes. In determining the amount of this tax, all of the distribution is treated as ordinary income, other than distributed income that was tax-exempt income to the trust. Finally, the amount of the tax on the distribution of the previously accumulated income is the amount of this tax reduced (but not below zero) by the amount of taxes paid on the distributed income by the trust.

The accumulation distribution rules generally do not apply if the income was accumulated while the beneficiary was a minor. However, this exclusion from the accumulation distribution rules does not apply if distributions had been made of income from two other trusts, which income also had been accumulated in that same year.

In addition, if distributions from two other trusts previously had been made of income that was accumulated in the same year as the present distribution of accumulated income, the gross-up and credit otherwise provided for the taxes paid by the trust on the distributed income is not allowed.

In the case of distributions by a foreign trust of previously accumulated income, the exemption from the accumulation distribution rules for amounts accumulated while the beneficiary was a minor does not apply. In addition, any tax on distributions of previously accumulated income is increased by an interest charge computed at 6 percent for each year from the time the income was earned until it was distributed.

Grantor trust rules

Present law contains rules (commonly called the "grantor trust rules") under which the grantor is treated as the owner of all or a portion of the trust if the grantor retains certain powers over, or interests in, the trust. In addition, a person other than the grantor is treated as an owner of all or a portion of the trust if that person originally had the power to revoke the trust and gave up that power to revoke but retains one of the powers or interests described below.

Reversionary interests

A grantor is treated as the owner of that portion of a trust in which he has a reversionary interest in corpus or income therefrom if the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years of the transfer to the trust. An exception is provided under which a grantor is not treated as having such a reversionary interest if the possession or enjoyment does not take effect until the death of the income beneficiary of that portion of the trust.

Power to control beneficial interest

A grantor is treated as the owner of any portion over which the grantor, or a nonadverse party, without the consent of an adverse party, has the power to control the beneficial enjoyment of the corpus or income from that portion of the trust. Present law provides the following exceptions to this rule:

(1) the power to apply the income for the support of a dependent so long as the power is not used to apply the income for the support of the dependent;

(2) any power to control beneficial enjoyment of the principal or income that takes effect only after 10 years from the transfer to the trust or after the death of the income beneficiary;

(3) a power exercisable solely by will other than powers which affect accumulated income in the trust;

(4) a power to allocate among charitable beneficiaries;

(5) a power to distribute corpus (a) to beneficiaries within a fixed class of beneficiaries which is subject to a reasonably definite standard or (b) to income beneficiaries where the corpus distribution is an advancement of that beneficiary's proportionate share of the trust;

(6) a power to withhold income temporarily from a beneficiary within a fixed class of beneficiaries where the withheld income must be distributed to that beneficiary or his estate or the beneficiary has a general power of appointment over that property;

(7) a power to withhold income during the disability of a beneficiary within a fixed class of beneficiaries;

(8) a power to allocate between income and corpus;

(9) a power held by an independent trustee to spray income and corpus among a fixed class of beneficiaries; and

(10) a power to allocate income or corpus to beneficiaries within a fixed class of beneficiaries that is subject to a reasonably definite external standard.

Administrative powers

A grantor is treated as the owner of a portion of the trust in respect of which—

(1) the grantor or a nonadverse party has the power to deal with the trust for less than adequate and full consideration;

(2) the grantor or a nonadverse party has a power which enables the grantor to borrow trust income or corpus without adequate interest or without adequate security;

(3) the grantor has borrowed income or corpus of the trust and has not repaid that amount before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by an independent trustee; and

(4) the grantor has retained the power exercisable in a nonfiduciary capacity (a) to vote stock of a corporation in which the holdings of the trust and the grantor are significant from a viewpoint of voting control, (b) to control the investments of the trust in such corporations, or (c) to reacquire trust corpus by substituting other property of equivalent value.

Power to revoke

The grantor is treated as the owner of a portion of a trust where the grantor has the power to revest the title to that portion in the grantor, other than a power that cannot affect the beneficial enjoyment of the property until after 10 years from the transfer to the trust or after the death of the income beneficiary.

Income for benefit of grantor

The grantor is treated as the owner of a portion of a trust if the income from that portion is, or in the discretion of the grantor or a nonadverse party may be (a) distributed to the grantor or the

grantor's spouse, (b) held for future distribution to the grantor or the grantor's spouse, or (c) applied to the payment of premiums on life insurance on the life of the grantor or the grantor's spouse. Present law provides an exception if the power can be exercised only after 10 years from the transfer to the trust or the death of the income beneficiary and if the power may be used to apply corpus or income of the trust to discharge the grantor's obligation of support of a dependent, unless the power is so exercised.

Foreign trusts having United States beneficiaries

A grantor who is a United States person is treated as the owner of any foreign trust for any year that the trust has a United States person as a beneficiary.

Alimony trusts

Present law provides another exception to the grantor trust rules in the case of certain alimony trusts. Under those rules, the income of the trust will be taxable to the grantor's former spouse, and not the grantor, if the income of the trust is payable to the former spouse of the grantor pursuant to a written separation agreement or under a decree of divorce. This exception does not apply with respect to amounts paid by the trust for the support of minor children.

Charitable remainder trusts and pooled income funds

Present law has special rules governing the taxation of trusts that have the remainder interests held by charitable organizations. These rules fall into two basic categories: charitable remainder trusts and pooled income funds.

Charitable remainder trusts

Charitable remainder trusts are of two types: charitable remainder unitrusts and charitable remainder annuity trusts. In the case of a charitable remainder unitrust, a fixed percentage of the fair market value of the trust's assets, determined at least annually, is distributed currently to beneficiaries, at least one of which is not a charitable organization, generally for a period of the life of an individual or a term of years not to exceed 20 years, with the entire remainder interest going to charitable organizations. In the case of a charitable remainder annuity trust, a fixed dollar amount is distributed currently to beneficiaries, at least one of which is not a charitable organization, generally for a period of the life of an individual or a term of years not to exceed 20 years, with the entire remainder interest going to charitable organizations.

In the case of both charitable remainder annuity trusts and charitable remainder unitrusts, no amounts can be distributed from the trust other than the annuity or unitrust amount. In addition, charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax unless they have any unrelated business taxable income for that year.

Distributions of the annuity or unitrust amount from both charitable remainder annuity trusts and charitable remainder unitrusts are treated as coming first, from current or accumulated ordinary

income; second, from current or accumulated capital gains; third, from current or accumulated other income; and lastly, from corpus.

Pooled income funds

A pooled income fund generally is a single trust to which several grantors have transferred property and which commingles the funds and pays out the income therefrom to one or more beneficiaries and the remainder interest in the trust goes to the charitable organization that maintains the trust. A pooled income fund cannot invest in tax-exempt securities.

A pooled income fund is allowed a deduction for amounts of income distributed to its beneficiaries and is allowed a charitable deduction for capital gains that are permanently set aside for the benefit of the charitable remainderman.

Cemetery perpetual care funds

Present law allows a limited deduction of $5 per gravesite for amounts spent by a cemetery perpetual care fund for the care and maintenance of gravesites that were purchased from the fund before the beginning of the taxable year.

Reasons for Change

While the committee believes that there are many nontax reasons for the creation of trusts, the committee is concerned about the inherent tax benefits arising under the present rules governing the taxation of trusts. The committee also is concerned about the overall level of complexity in the present rules governing the taxation of trusts, estates, and their beneficiaries.

The present rules relating to the taxation of trusts provide tax benefits in basically four ways. First, present law permits the creation of separate taxpayers (entitled to separate rate schedules and personal exemption deductions) through the creation of one or more trusts. Second, present law permits the deferral of tax on income earned by trusts and estates through the selection of taxable years that do not coincide with the taxable years of the beneficiaries. Third, the taxation of the stream of income from assets can be separated from the ownership of those assets through the use of trusts. Finally, taxes on income from assets held in trust can be minimized by spraying income through discretionary trusts to those beneficiaries with the lowest taxable incomes.

In addition, the committee is concerned with the overall complexity of the taxation of trusts and estates. Present law relies upon a series of complex rules which include rules (1) defining distributable net income, (2) allocating expenses among classes of income included in distributable net income, (3) allocating the distributable net income between the trust or estate, its beneficiaries, and charities, (4) taxing previously accumulated income, and (5) taxing grantors or other beneficiaries if they retain certain powers over, or interests in, the trust that allows them to benefit from, or to control, the trust.

Most of these problems arise because present law provides separate tax rates to trusts or estates and taxes beneficiaries on distributions from the trust or estate. The committee bill attempts to

solve these problems by taxing the trust or estate on its income at the grantor's marginal tax rates or the beneficiary's marginal tax rates where all or a portion of the trust belongs to that beneficiary.

Once the income of the trust is properly taxed, the committee believes that distributions from the trust or estate should not be taxed to the beneficiaries. Thus, the complex rules relating to distributable net income, allocation of expenses, the tier system, and accumulation distributions are no longer necessary.

Taxing the income of the trust or estate at the marginal tax brackets of the grantor until all of the assets of the trust (or identifiable portion of the trust) belong to a particular beneficiary prevents the creation of separate taxable entities, the severing of the taxation of the income from the ownership of assets, and the ability to spray taxable income to the lowest bracket beneficiaries. Moreover, use of the grantor's marginal tax brackets permits significant simplification of the grantor trust rules because no significant tax savings can occur through the creation of a trust. The committee believes, however, that a grantor should continue to be treated as the owner of the trust if, in effect, the grantor or his spouse can benefit currently from the assets of the trust.

The committee believes that these changes will significantly simplify the taxation of trusts, estates, and their beneficiaries without allowing the tax benefits inherent in the present law rules. The committee also believes that the committee bill achieves these goals without creating any tax penalties that would prevent the use of trusts for valid business and estate planning purposes.

Explanation of Provisions

1. Overview

Under the committee bill, the income of most non-grantor trusts is taxed during the lifetime of the grantor at the top marginal tax rate of the grantor without a deduction for distributions to beneficiaries. This is accomplished by allowing the grantor to allocate any of the grantor's unused tax brackets to trusts created by that grantor. After the death of the grantor, the income from the grantor's estate and all trusts created by the grantor is taxed without a distribution deduction and by allocating one set of tax brackets among the grantor's estate and all trusts created by the grantor.

If one beneficiary is entitled to all distributions from a trust and all undistributed amounts are ultimately subject to the control of the beneficiary (called a "qualified beneficiary trust"), the income of that trust (computed without a deduction for distributions) is taxed at the top marginal tax rates of the beneficiary. This is accomplished by allowing the beneficiary of such a trust to allocate any unused tax brackets of the beneficiary to that trust.

Where all of the beneficiaries of a trust are children of the grantor (called a "qualified children's trust"), any beneficiary may allocate any of his or her unused tax brackets to the trust for any year prior to the time that beneficiary reaches his majority.

Under the committee bill, a grantor of a trust is treated as the owner of the trust if the grantor retains a power to revoke the trust, the grantor retains the right to receive the trust income or the power to use the income of the trust for the benefit of the

grantor or the grantor's spouse, and if the grantor retains certain administrative powers that permit the grantor or the grantor's spouse to benefit from the trust.

Distributions from foreign trusts are subject to the highest individual marginal rate (38 percent under the committee bill) unless the fiduciary of the foreign trust elects to be subject to current taxation by the United States. If the fiduciary so elects, the foreign trust is taxed as a domestic trust. The taxation of charitable remainder trusts and pooled income funds generally is not affected by the committee bill.

The committee bill generally applies to trusts created, and to contributions made to existing trusts, after Sepember 25, 1985.

2. General rule for non-grantor trusts when grantor is alive

Assignment of unused rate brackets

Except in the case of a qualified beneficiary trust or a qualified children's trust, all trusts created by a grantor that are not treated as grantor trusts are taxed at the marginal tax rates of the grantor. This is accomplished by allowing the grantor to allocate any of the grantor's unused tax rate bracket amounts for any year to the trusts created by him in any manner he elects. For example, if a grantor has income of $60,000 for a year and files a joint return, there is $40,000 of unused tax bracket in the 35 percent marginal bracket. Under the committee bill, the grantor could allocate that $40,000 of 35 percent bracket among any trusts created by him. If he allocated all of the $40,000 to one trust, the tax on that trust would be computed by taxing the first $40,000 of income at 35 percent and the balance of such income at 38 percent. The taxable income of any other trust created by that grantor would be taxed at a rate of 38 percent.

The grantor will make the allocation as provided by the Secretary of the Treasury.[3] If a trustee does not receive notification of any unused bracket allocated to the trust of which he is trustee, the trustee computes the trust's tax using the top marginal rate applicable to individuals (38 percent under the committee bill).

Once the grantor has elected to allocate his unused tax brackets to one or more trusts created by him for a particular taxable year, that election is irrevocable. Thus, the tax liability of the grantor and the trusts for that year are computed as if they were subject to tax rate schedules consistent with that election. For example, in the example above, if the grantor subsequently was determined to have more taxable income, that income would be taxed at 38 percent—as if the 35 percent bracket stopped for him at $60,000 of income. Thus, the taxes of trusts created by a grantor are not affected by adjustments to that grantor's taxable income. Similarly, the income of non-grantor trusts created by a grantor does not affect the taxation of the grantor (other than the change in the

[3] The committee contemplates that the Secretary of the Treasury may provide for an allocation method by which the grantor would file a two-part form with his income tax return for the year. One part of the form would be sent to the IRS and would indicate the grantor's name and identification number, the names and identifying numbers of the trust or trusts to which he is allocating his unused tax brackets, and the amount of each unused tax bracket allocated to each trust. The second part of the form would be sent to the trustee or trustees.

rate schedule applicable to that grantor by reason of the grantor electing to allocate his unused tax brackets to his trusts).

Computation of the taxable income of trusts

General rule.—Under the committee bill, a trust generally computes its taxable income in the same manner as an individual. Also, as under present law, the fiduciary of the trust is liable to pay the tax imposed on the trust.

Charitable deduction.—Under the committee bill, the rules governing the charitable deduction of trusts generally are retained. Thus, a trust is allowed an unlimited deduction for any amounts of gross income which, pursuant to the terms of the governing instrument are, during the taxable year (or, at the election of the trustee, within the following taxable year), paid for a charitable purpose (i.e., a purpose described in sec. 170 (c)(2)(A)). Charitable deductions from any unrelated business income of the trust are restricted as under present law. However, if it is more probable than not that any of the trust will revert back to the grantor, the grantor's spouse (or, in the case of grantors which are corporations, a related corporation), the same percentage limitations on the charitable deduction applicable to the grantor would apply to the trust.

Personal exemption.—Under the committee bill, all trusts are entitled to a deduction, in lieu of a personal exemption, of $100 (i.e., the same deduction as complex trusts receive under present law).

Other items.—Under the committee bill, trusts and estates are entitled to a net operating loss deduction, as under present law. In addition, any unused losses and deductions in the last year of the trust or estate may be claimed by the beneficiaries in accordance with the rules of present law. Since beneficiaries are not taxed on the income of the trust or estate, the special rules that allocate depreciation, depletion, and certain amortization deductions directly to beneficiaries are repealed. All of such deductions are to be taken by the trust or estate.

Taxable years

Under the committee bill, the taxable year of the trust may be a year different than that of the grantor. When a grantor or beneficiary assigns unused tax brackets to a trust, the rate brackets apply to the taxable year of the trust that begins with or within the taxable year of the grantor or beneficiary from whom those brackets are assigned.

Muitiple grantors

If a trust is created by more than one grantor, the portions of the trust attributable to contributions from different grantors are treated as separate trusts for all Federal income tax purposes. If transfers are made to a trust by a husband or wife (or both) while they are married, the spouses could elect, on the trust's first tax return, to treat one spouse as the grantor with respect to all such transfers to the trust.

Alternative minimum tax

In the case of the alternative minimum tax, both the grantor and the trusts created by that grantor compute any minimum tax li-

ability based upon the alternative minimum taxable income of the grantor and trusts, respectively. However, the alternative minimum tax exemption is allocated between the grantor and the trusts created by the grantor (or grantor's estate) in the same proportion that the income tax brackets are allocated between the grantor and the trusts (or grantor's estate).

Taxation of distributions

Under the committee bill, distributions from the trust or estate are not taxable to the beneficiaries of the trust or estate. In the case of distributions of property, the basis of the property in the hands of the beneficiary is the same as the basis of that property in the hands of the trust or estate, adjusted for any gain or loss recognized to the trust on the distribution. The committee bill does not change the rules of current law that recognize gain on certain distributions of a trust or estate (e.g., distributions in satisfaction of a pecuniary bequest).

Foreign trusts

The committee bill provides that distributions from foreign trusts are subject to tax at the top marginal tax rate applicable to individuals, unless the fiduciary of the trust elects to be subject to current taxation by the United States. If the fiduciary of a foreign trust elects current taxation by the United States, the trust is taxed as a domestic trust. If the fiduciary of a foreign trust does not so elect, current distributions are taxed at the highest marginal rate applicable to individuals. Similarly, if the fiduciary does not so elect, the partial tax on accumulation distributions is determined at the highest marginal tax applicable to individuals and the interest charge on such accumulations (sec. 10668) is determined on that partial tax.

Charitable trusts

Under the committee bill, present law continues with respect to charitable remainder trusts (described in sec. 664 of present law) and pooled income funds (described in sec. 642(c)(5) of present law).

Alimony trusts

Under the committee bill, in the case of a trust established pursuant to a decree of divorce or separate maintenance, all amounts distributed by the trust to the spouse that are in the nature of alimony are included in the spouse's gross income under section 71 without regard to the source of the distribution or the character of the income from which it is derived. In addition, the trust is entitled to an alimony deduction under section 215.

3. General rule when grantor is deceased

The taxation of trusts created by a grantor after his death is very similar to their taxation before his death. After the grantor's death, the grantor's estate and all trusts created by the grantor have one set of tax brackets (those applicable to a married individual filing separately) that may be allocated among the decedent's estate and all of the trusts created by that grantor. The allocation is to be made by the grantor in his will. If the grantor does not

make such an allocation in his will, the tax brackets are to be allocated among the grantor's estate and all of the trusts created by that grantor in accordance with the agreement of those trustees and the executor of the grantor's estate. Only trusts that notify the executor within nine months of the date of the grantor's death are eligible to receive an allocation. This agreement may specify changes in the allocation over time, such as when a trust or estate terminates. In the absence of a provision in the will or such an agreement, the tax brackets are allocated in equal shares among the estate and all trusts that notify the executor within the nine-month period.

4. Qualified beneficiary trusts

Where all of the income and principal of a trust is irrevocably allocated to a particular individual or his estate during all times during a taxable year and at all times thereafter, the income of that trust for that taxable year is taxed at the marginal rates of that beneficiary (and not the grantor). For purposes of these rules relating to qualified beneficiary trusts, the committee intends that substantially separate and independent shares of different beneficiaries in a trust are treated as separate trusts. The beneficiary may allocate any of his unused tax brackets to that trust in the same manner, and with the same effect, as a grantor would allocate unused tax brackets to a nongrantor trust. If the beneficiary of a qualified beneficiary trust is under age 14 and at least one parent is alive, the committee bill provides that no unused tax brackets of that child may be allocated to the qualified beneficiary trust.

In order to be a qualified beneficiary trust, both the income and principal of the trust must be devoted irrevocably to that individual for the entire taxable year and at all times thereafter. Thus, during the lifetime of the beneficiary, distributions from the trust may only be made to, or for the benefit of, the beneficiary. After the death of the beneficiary, the entire corpus (including any undistributed income) of the trust must either (1) be distributed to the estate of the beneficiary or (2) be subject to a general power of appointment exercisable by the beneficiary. For purposes of this rule, a qualified beneficiary trust includes any trust for the benefit of the spouse of the grantor which qualifies as qualified terminable interest property.

If the assets of a qualified beneficiary trust are held in further trust following the beneficiary's death (whether by lapse of a general power of appointment or otherwise), the trust is treated as created by the beneficiary for purposes of taxation of the trust after the beneficiary's death.

5. Qualified children's trusts

If all of the beneficiaries of a trust are natural or adopted children of the grantor, any child may allocate to the trust any of his or her unused tax brackets for a taxable year during which the child was a minor for the entire taxable year of the trust. The tax brackets of the children allocable to such a trust are in addition to any tax brackets allocated to that trust by the grantor. Under the committee bill, any passive income of a child under age 14 that is derived from transfers from his or her parents generally is taxed at

the unused tax brackets of the parent. Accordingly, if the child is under age 14, no unused rate brackets of that child can be allocated to the qualified children's trust of which he or she is a beneficiary.

In order to be a qualified children's trust, all of the principal and income of the trust must be devoted irrevocably for that year and all subsequent years to the children of the grantor. However, the amount of principal or income to which any child is entitled need not be fixed, provided that any power to allocate income or corpus among the children is held by an independent trustee. For example, a trust could be a qualified children's trust where a grantor transfers property in trust to pay the income to his children for their lives in such proportions as the trustee (who is an independent trustee) in the trustee's discretion determines, remainder to his children per stirpes (or otherwise among his children). A qualified children's trust also may allow after-born children or the descendants of a deceased child of the grantor to become beneficiaries.

The tax liability of a qualified children's trust is determined by adding the unused brackets allocated to the trust by the grantor and the minor children. For example, assume that the grantor allocated $10,000 of his 25 percent bracket and all $57,000 of his 35 percent bracket to the trust, that the grantor's minor child is under age 14, and that the remainder of the grantor's children are no longer minors. The first $10,000 of trust income is taxed at 25 percent; the next $57,000 of trust income is taxed at 35 percent; and any remaining trust income is taxed at 38 percent.

In the case of the minor child, the election to allocate his unused brackets to the trust would be made on the child's income tax return. An income tax return must be filed to allocate the unused bracket amount even if the child would not otherwise have to file an income tax return.

A trust which is a qualified beneficiary trust (i.e., a trust for one child) does not qualify as a qualified children's trust.

6. Grantor trusts

Under the committee bill, the taxation of grantor trusts is not significantly changed, but the number of cases subject to those rules is reduced.

Under the committee bill, the grantor is treated as an owner of the trust and, therefore, is taxed directly on the income of the trust in the following three circumstances (all of which are consistent with the treatment under present law):

First, if the grantor or the grantor's spouse retains the power to deal with the trust for less than adequate and full consideration, where the grantor or the grantor's spouse retains the power to borrow without adequate interest or security, or where the grantor or the grantor's spouse has borrowed from the trust and not repaid that amount before the beginning of the taxable year;

Second, if the trust is subject to a power to revoke which enables the grantor or the grantor's spouse to revest part or all of the trust in the grantor or the grantor's spouse; or

Third, if any portion of the income of the trust is required to be or may, in the discretion of the grantor or the grantor's spouse, be distributed to the grantor or the grantor's spouse, held for future

distributions to the grantor or the grantor's spouse, or applied to the payment of premiums on life insurance policies on the grantor or the grantor's spouse. Income that may be used, in the discretion the trustee, to discharge an obligation of support of the grantor or the grantor's spouse is not be taxable to the grantor except to the extent that the income is actually used to discharge that obligation of support.

A person other than the grantor is treated as the owner of a trust where that person had a power to revoke and retained one of the powers listed above.

The committee bill clarifies that, if a trust is treated as a grantor trust, the grantor (or beneficiary, where appropriate) is treated as the owner of the property for all Federal income tax purposes.[4]

7. Taxation of estates

In general

Under the committee bill, estates compute their tax liability similarly to that of any trust created by the grantor. The income of the estate is determined as under present law, except that no distribution deduction is allowed. Estates are entitled to a deduction, in lieu of a personal exemption, of $600 (i.e., the same deduction as under present law).

The income of the estate (as so determined) is taxed in accordance with that portion of the one set of rate brackets allocated to the estate in accordance with the grantor's will (or, if no such designation is made, in accordance with an agreement made by the executor and the trustee of trusts created by the grantor or, if no agreement is reached, in equal amounts to the estate and trusts created by the grantor).

In order to ease the administration of estates, the committee bill provides that the executor of an estate may elect to change its accounting period one time without the approval of the Internal Revenue Service. The ability to change accounting periods permits the executor to isolate transactions with potential tax disputes in a short taxable year that will be audited sooner than if the regular taxable year had been used.[5]

Taxable year of death

The committee bill provides an election to extend the taxable year of the decedent until the end of the decedent's normal taxable year, instead of having the decedent's final taxable year terminate on the date of death as provided by present law. If this election is made, all of the income, deductions, and credits of the estate during the remainder of that taxable year are included in the decedent's return for that year. The election must be made on the decedent's final income tax return. Where a joint return for the decedent's final year is made with the surviving spouse, the surviving spouse must consent to the election.

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[4] In this regard, the committee bill is inconsistent with the result reached by the Second Circuit Court of Appeals in the case of *Rothstein v. Commissioner*, 735 F 2d 704 (1984). No inference is intended as to whether the decision of that case is correct under present law. *See* Rev. Rul. 85-1, 1985-1 IRB 6.

[5] This same election is available to fiduciaries of bankruptcy estates. (*See* sec. 1398(j)(1).)

Effective Date

The provisions relating to trusts apply to trusts created, and to contributions made to existing trusts on or after September 25, 1985.[6] In addition, the amendments relating to estates apply to estates of decedents dying on or after September 25, 1985.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $97 million in 1986, $325 million in 1987, $334 million in 1988, $373 million in 1989, and $426 million in 1990.

[6] The committee intends that transfers after September 25, 1985, from one trust created before September 25, 1985, to another trust created before September 25, 1985, are not to be treated as a contribution to a trust after September 25, 1985.

C. Generation-Skipping Transfer Tax (Secs. 1221-23 of the bill and chapter 13 of the Code)

Present Law

Overview

A generation-skipping trust is defined as a trust which provides for the splitting of benefits between two or more generations that are younger than the generation of the grantor. A generation-skipping transfer tax, substantially equivalent to the estate tax that would have been imposed on direct transfers to each generation, is imposed on certain distributions from, and terminations of interests in or powers over, such trusts.

The tax is imposed when trust assets are distributed to a generation-skipping beneficiary or upon the termination of an intervening interest in the trust. No tax is imposed on outright transfers to generation-skipping beneficiaries.

No tax is imposed if the younger generation beneficiary has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

In addition, present law provides an exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

Imposition of tax

A generation-skipping transfer is defined as a transfer to a beneficiary at least two generations younger than the transferor. Generation-skipping transfers are subject to tax if made under a trust or similar arrangement. No tax is imposed in the case of outright transfers to generation-skipping beneficiaries.

Taxable events

A generation-skipping transfer tax is imposed on the occurrence of either a *taxable termination* or a *taxable distribution*.

A *taxable termination* means the termination of an interest or power of a younger generation beneficiary who is a member of a generation which is older than that of any other younger generation beneficiary of the trust. Such a termination generally occurs by reason of death (in the case of a life interest) or by lapse of time (in the case where the grantor created an estate for years).

For example, if a trust provides income for life to the grantor's child, with remainder to the grantor's grandchild, there is a taxable termination of the child's interest upon his or her death because this death terminates the interest (in this case, a life income interest) of a younger generation beneficiary (the child) who is a member of a generation older than that of any other younger gen-

eration beneficiary (the grandchild) of the trust. For purposes of determining whether there has been a generation-skipping transfer, the determination as to whether there are younger generation beneficiaries is made immediately before the transfer takes place.

Special rules postpone the taxable termination (and thus the imposition of the tax) in cases involving future interests or powers, multiple beneficiaries, and discretionary interests.

A *taxable distribution* occurs whenever there is a distribution from a generation-skipping trust, other than a distribution out of accounting income (sec. 643(b)) to a younger generation beneficiary of the trust, and there is at least one other younger generation beneficiary who is a member of an older generation than the distributee. For example, assume that a discretionary trust is established for the benefit of the grantor's child and grandchild. The trustee exercises its discretion by distributing accounting income to the child and also makes a distribution out of corpus to the grandchild. This would constitute a taxable distribution because there would be at least one younger generation beneficiary (the child) who was a member of a generation older than that of the grandchild.

Where there are distributions out of corpus as well as out of income, the distributions to members of the oldest generation (whether or not they are younger generation beneficiaries) are treated as having been made out of income (to the extent of the income), and the distributions to younger generations are to be treated as having been made out of any remaining income, and then out of corpus.

The terms *taxable termination* and *taxable distribution* do not include any amounts which are subject to gift or estate tax (for example, because the beneficiary whose interest in a trust has terminated had a general power of appointment with respect to the trust property). Where both a termination and a distribution result from the same occurrence (such as the death of a member of an intervening generation), the transfer is treated as a termination.

Generation assignment

A generation-skipping trust is a trust having two or more generations of "beneficiaries" who belong to generations which are "younger" than the generation of the grantor of the trust. For purposes of the generation-skipping transfer tax provisions, a "grantor" of the trust includes any person contributing or adding property to the trust.

Generally, generations are determined along family lines where possible. For example, the grantor, his or her spouse and brothers and sisters are one generation; their children (including adopted children) are the first younger generation; the grandchildren constitute the second younger generation, etc. Spouses of family members are assigned to the same generation as the family member to whom they are married.

Where generation-skipping transfers are made outside the family, generations are measured from the grantor. Individuals not more than 12 1/2 years younger than the grantor are treated as members of the grantor's generation; individuals more than 12 1/2 years younger than the grantor, but not more than 37 1/2 years

younger, are considered members of his or her children's generation, and so forth.

Exemptions from tax

Unified credit

Because the tax is based upon the transfer tax history of the deemed transferor, a generation-skipping trust is entitled, in calculating the tax arising after the death of such deemed transferor, to any unused portion of his or her unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

Exemption for certain transfers to grandchildren

Present law provides a special exemption from tax if the younger generation beneficiary has nothing more than (1) a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. In addition, a special exclusion is provided for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

Computation of tax

Rate of tax

The present generation-skipping transfer tax is substantially equivalent to the tax that would have been imposed if the property actually had been transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's child during the child's life, with remainder to a grandchild. Upon the death of the child, the generation-skipping transfer tax is computed by adding the child's portion of the trust assets to the child's estate and computing the tax at the child's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the child is treated under present law as the "deemed transferor" of the trust property. The deemed transferor's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer. Under present law, the applicable rate on taxable transfers ranges from 18 percent on the first $10,000 in taxable transfers to 55 percent on transfers in excess of $3 million.

Tax base and payment of tax

In the case of a *taxable distribution*, the amount subject to tax is the value of the money and property distributed (determined as of the time of the distribution). The tax base includes the transfer taxes paid under these rules with respect to the distribution, regardless of whether these taxes are paid by the beneficiary out of the proceeds of the distribution, or the taxes are paid by the trustee out of trust monies which are paid over directly to the Government. In the case of a *taxable termination*, the tax base equals (1) the value of the trust property in which an interest has terminated

and/or (2) the value of the property which was the subject of a power (where a power has terminated).

Neither the deemed transferor nor his or her estate is liable for the tax imposed under these provisions. Generally, the tax is paid out of the proceeds of the trust property. In the case of a *taxable distribution*, however, the distributee of the property is personally liable for the tax to the extent of the fair market value of the property which he or she receives (determined as of the date of the distribution). In the case of a *taxable termination*, the trustee is personally liable for the tax. However, the trustee is permitted to file a request with the Internal Revenue Service for information concerning the transfer tax rate bracket of the deemed transferor. Where the transfer is to a grandchild of the grantor of the trust, the trustee may also request information concerning the extent to which the $250,000 exclusion of the deemed transferor has not been fully utilized. The trustee is not liable for tax to the extent that any shortfall in the payment of the tax ultimately determined to be due results from the trustee's reliance on the information supplied by the Internal Revenue Service, in response to either of these requests.

Credit for State taxes

Because the generation-skipping transfer tax is calculated by reference to the transfer tax history of the deemed transferor, the generation-skipping trust is entitled to any unused portion of the deemed transferor's credit for state death taxes.

No specific credit is provided with respect to the payment of state generation-skipping transfer taxes.

Coordination with other provisions

Estate tax

To the extent consistent with the specific provisions concerning generation-skipping transfers, the rules of the Code relating to the gift tax apply in cases where the deemed transferor is alive at the time of the generation-skipping transfer, and the rules relating to the estate tax apply where the generation-skipping transfer occurs at or after the death of the deemed transferor.

To the extent that transfers are subject to the generation-skipping transfer tax as a result of the death of the deemed transferor, present law permits utilization of the unused estate tax deductions and credits of the deemed transferor. Thus, the generation-skipping transfer tax is calculated after taking into account such items as the unified credit, the State death tax credit, the previously taxed property credit, and remaining deductions for charitable bequests and administration expenses actually sustained by the trust.

The alternate valuation date is available where a taxable termination occurs as a result of the death of the deemed transferor. In this case, the election to use the alternate valuation date is made by the trustee of the generation-skipping trust (who is also the person liable for the tax under these circumstances); it is not required that the executor of the deemed transferor's estate also elect that provision.

Income tax

Where certain rights to income are subject to the tax on generation-skipping transfers, the income tax treatment of so-called "income in respect of a decedent" may apply to this income. Thus, the recipient of this income is entitled to a deduction (in computing income tax on this income) for the generation-skipping transfer tax in the same way as that recipient is allowed a deduction for the estate tax imposed on these items (sec. 691(c)). Also, where a generation-skipping transfer which is subject to tax occurs as a result of the death of the deemed transferor, section 303 treatment, which permits certain tax-free redemptions of stock to pay estate tax, is available. The trust and the actual estate of the deemed transferor are treated separately for purposes of the section 303 qualification requirements.

Reasons for Change

The committee believes, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) is not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations. The committee determined that the present generation-skipping transfer tax is unduly complicated. Therefore, the committee determined that this tax should be replaced with a simplified tax, determined at a flat rate. The bill accomplishes the committee's goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner.

Explanation of Provisions

1. Overview

The bill amends the existing generation-skipping transfer tax, which attempts to determine the additional gift or estate tax that would have been paid if property had been transferred directly from one generation to another, to impose a simplified tax determined at a flat rate. The generation-skipping transfer tax is expanded to include direct generation-skipping transfers (e.g., a direct transfer from a grandparent to a grandchild) as well as transfers (subject to tax under the existing tax) in which benefits are "shared" by beneficiaries in more than one younger generation.

Transfers of up to $1 million per grantor are exempt from tax. Additional exemptions are provided for certain transfers that are not subject to gift tax and for direct transfers to grandchildren of the transferor if the aggregate amount of such transfers does not exceed $2 million per grandchild.

2. Imposition of tax

As under present law, a generation-skipping transfer is defined as a transfer to a beneficiary at least two generations younger than the transferor. Thus, only transfers to grandchildren or younger

generations are subject to tax. Generation-skipping transfers are subject to tax whether in trust, pursuant to an arrangement similar to a trust, or outright.

In general, the bill retains the present-law rules on generation assignment, except that lineal descendants of the grandparents of the transferor's spouse also are assigned to generations on a basis like that for such descendants of the transferor.

Taxable events

A generation-skipping transfer tax is imposed on the occurrence of any one of three events—a *taxable distribution*, a *taxable termination*, or a *direct skip*.

The first two events generally involve transfers that are taxable under present law. A *taxable distribution* occurs upon distribution of property to a generation-skipping beneficiary (e.g., a grandchild). A *taxable termination* occurs upon the expiration of an interest in a trust if, after that termination, all interests in the trust are held by generation-skipping beneficiaries. Persons holding interests in property are defined to include only those persons having a current right to property (or income therefrom) or persons who are current permissible recipients of the property (or income therefrom). For example, a person having an income interest for life or a holder of a general power of appointment is treated as having an interest in property.

A *direct skip* occurs upon an outright transfer for the benefit of a person at least two generations below the transferor or a transfer of property to a trust for one or more such beneficiaries. As described in the *Overview*, an example of a direct skip is a gift from a grandparent to his or her grandchild.

Effect of disclaimers

A disclaimer that results in property passing to a person at least two generations below that of the original transferor results in imposition of the generation-skipping transfer tax. For example, if a child of a decedent makes a qualified disclaimer, and, under local law, the disclaimed property passes to the grandchildren of the decedent, a generation-skipping transfer tax is imposed on the transfer (in addition to any estate tax to which the transfer is subject). Under the general source of tax rule applicable to the transfer taxes, the disclaimed property, rather than the decedent's estate generally, is primarily liable for payment of the generation-skipping transfer tax.

Tax on income distributions

Unlike present law, the bill provides that generation-skipping distributions from a trust are subject to tax whether the distributions carry out trust income or trust corpus. However, an income tax deduction is allowed to the recipient for the generation-skipping transfer tax imposed on the distribution.

Tax on trusts providing for generation-skipping transfers to more than one younger generation

A single trust may provide for transfers to more than one generation of generation-skipping beneficiaries. For example, a trust

may provide for income payments to the grantor's child for life, then for such payments to the grantor's grandchild, and finally for distribution of the trust property to the grantor's great-grandchild. Were such property left outright to each such generation, the property would be subject to gift or estate tax a total of three times. Under the bill, the property likewise is subject to transfer tax a total of three times—gift or estate tax on the original transfer and generation-skipping transfer tax on the transfers to the grandchild and the great-grandchild.

3. Exemptions from tax

$1 million exemption

The bill provides an exemption of up to $1 million for each person making generation-skipping transfers. In the case of transfers by a married individual, the individual and his or her spouse may elect to treat the transfer as made one half by each spouse. In addition, an individual may allocate all or a portion of his or her specific exemption to property with respect to which a generation-skipping transfer will occur upon its disposition by (or on the death of) the transferor's spouse as a result of an election to treat that property as qualified terminable interest property (QTIP property). (*See*, secs. 2056(b)(7) and 2523(f)). Once a transfer, or portion of a transfer, is designated as exempt, all subsequent appreciation in value of the exempt property also is exempt from generation-skipping transfer tax.

The operation of the specific exemption may be illustrated by the following example. Assume a grantor transfers $1 million in trust for the benefit of his or her children and grandchildren. If the grantor allocates $1 million of exemption to the trust, no part of the trust will ever be subject to generation-skipping transfer tax—even if the value of the trust property appreciates in subsequent years to $10 million or more. On the other hand, if the grantor allocates only $500,000 of exemption to the trust, one-half of all distributions to grandchildren will be subject to tax and one-half of the trust property will be subject to tax on termination of the children's interest. If, after creation of the trust, the grantor allocates an additional $250,000 of exemption to the trust, the exempt portion of trust will be redetermined, based upon the values of the trust property at that time. This new inclusion ratio applies to future distributions and terminations, but generally does not change the tax treatment of any past events.

Exemption for nontaxable gifts

The generation-skipping transfer tax does not apply to any *inter vivos* transfer which is exempt from gift tax pursuant to either the $10,000 annual exclusion or the special exclusion for certain tuition and medical expense payments.

Special exemption for certain direct skips to grandchildren

A special exemption from the generation-skipping transfer tax is provided for certain direct skips (either in trust or otherwise) to grandchildren of the grantor. For each grantor, this special exemption is limited to $2 million per grandchild. As is true with taxable

generation-skipping transfers and taxable gifts, married individuals may elect to treat these exempt transfers as made one-half by each spouse.

Special exemption for certain other transfers to grandchildren

The bill also provides a special rule on generation assignment for grandchildren of the grantor when a grandchild's parent who is a lineal descendant of the grantor is deceased. In such a case, the grandchild and all succeeding lineal descendants of the grandchild are "moved up" a generation. Thus, transfers to such grandchild are not taxed as generation-skipping transfers.

4. Computation of tax

Rate of tax

The rate of tax on generation-skipping transfers is equal to the maximum gift and estate tax rate. Thus, the tax rate is 55 percent until 1988, when it is scheduled to decline to 50 percent.

Tax base and payment of tax

The tax base and method of paying the generation-skipping transfer tax generally parallels the method applicable to the most closely analogous transfer subject to gift or estate tax. Generation-skipping transfers, therefore, are taxed as follows:

Taxable distributions.—The amount subject to tax is the amount received by the transferee (i.e., the tax is imposed on a "tax-inclusive" basis). The transferee pays the tax on a taxable distribution. (If a trustee pays any amount of the tax, the trustee is treated as making an additional taxable distribution of that amount.)

Taxable terminations.—The amount subject to tax is the value of the property in which the interest terminates (i.e., the tax is imposed on a "tax-inclusive" basis). The trustee pays the tax on a taxable termination.

Direct skips.—The amount subject to tax is the value of the property received by the transferee (i.e., the tax is imposed on a "tax-exclusive" basis). The person making the transfer pays the tax on a direct skip.

Credit for State taxes

A credit not exceeding five percent of the amended Federal tax is allowed for generation-skipping transfer tax imposed by a State with respect to taxable transfers occurring by reason of death.

5. Coordination with other provisions

The bill also includes several provisions coordinating the generation-skipping transfer tax with the gift and estate taxes. The Code provisions governing administration of the gift and estate taxes also apply to the amended generation-skipping transfer tax. Estate tax rules apply to generation-skipping transfers occurring as a result of death, and gift tax rules apply in other cases.

In addition to any adjustment to basis received under the gift or estate tax basis provisions, the basis of property subject to the amended generation-skipping transfer tax generally is increased by the amount of that tax attributable to the excess of the property's

value over the transferor's basis. In the case of taxable terminations occurring as a result of death, a step-up in basis like that provided under the estate tax (sec. 1014) is provided.

Property transferred in a direct skip occurring as a result of death has the same value for purposes of the generation-skipping transfer tax as the property has for estate tax purposes. Thus, if the transferor's estate elects the alternate valuation date or the current use valuation provision, the value under those provisions is used in determining the generation-skipping transfer tax. In addition, even if an estate does not elect the alternate valuation date, an election may be made to value any property transferred in a taxable distribution or a taxable termination on the alternate valuation date if the distribution or termination occurs as a result of death and the requirements of that provision are satisfied.

The special rules under which estate tax attributable to interests in certain closely held businesses may be paid in installments also apply to direct skips occurring as a result of death.

The provision permitting tax-free redemptions of stock to pay estate tax is amended to permit those redemptions to pay generation-skipping transfer tax in the case of such transfers occurring as a result of death.

Effective Dates

The amended generation-skipping transfer tax applies to transfers after the date of enactment, subject to the following exceptions:

(1) Inter vivos transfers occurring after September 25, 1985, are subject to the amended tax;

(2) Transfers from trusts that were irrevocable before September 26, 1985, are exempt to the extent that the transfers are not attributable to additions to the trust corpus occurring after that date; and

(3) Transfers pursuant to wills in existence before September 26, 1985, are not subject to tax if the decedent was incompetent on that date and at all times thereafter until death.

The existing generation-skipping transfer tax is repealed, retroactive to June 11, 1976.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $3 million in 1987, $7 million in 1988, $7 million in 1989, and $8 million in 1990.

TITLE XIII—COMPLIANCE AND TAX ADMINISTRATION

A. Penalties

1. Penalties for Failure to File Information Returns or Statements (Sec. 1301 of the bill and new secs. 6721, 6722, 6723, and 6724 and secs. 6652, 6676, and 6678 of the Code)

Present Law

The Code requires that information returns be filed with the IRS, and a copy be given to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for failure either to file an information return with the IRS (sec. 6652) or to provide a copy to the taxpayer (sec. 6678). Thus, the general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to give a copy to the taxpayer. Generally, these penalties are $50 for each failure; the maximum penalty under each provision is $50,000 per year.

The Code also provides a penalty of either $5 or $50 (depending on the nature of the failure) for failure to furnish a correct taxpayer identification number (for individuals, the social security number) (sec. 6676). The Code does not provide a penalty for including other incorrect information on an information return.

Reasons for Change

The committee believes that simplifying these penalties, consolidating them, and making them more comprehensible will have a beneficial impact on compliance. Taxpayers will be able to understand more easily the consequences of non-compliance, and the administration of these penalties by the IRS should be facilitated by this simplification and consolidation.

The committee also believes that persons required to file these information returns (and provide the copies for taxpayers) who include incorrect information on them should be subject to a penalty.

The committee is concerned that the current maximum of $50,000 for each of these penalties may diminish the efficacy of these penalties in instances where there has been a massive failure to file these information returns. The committee is also concerned, however, that total elimination of these maximum amounts could subject taxpayers to enormous potential liability that would be disproportionate both to the taxpayer's culpability and to the penalties for many other Federal offenses. Consequently, the committee has preserved a maximum amount for each of these penalties, but has also raised the dollar amounts of those maximums.

Explanation of Provision

The bill consolidates the penalty for failure to file an information return with the IRS with the penalty for failure to supply a copy of that information return to the taxpayer in the same subchapter of the Code. The general level of each of these penalties remains at $50 for each failure. The maximum penalty is raised from $50,000 to $100,000 for each category of failure.[1] Thus, a maximum penalty of $100,000 applies to failure to file information returns with the IRS, and another maximum penalty of $100,000 applies to failure to supply copies of information returns to taxpayers.

The bill imposes these penalties without limits where the failure to file information returns with the IRS is due to intentional disregard of the filing requirement, which also occurs under present law. The bill also provides, as does present law, generally higher penalties for each failure to file where the failure to file is due to intentional disregard. The bill modifies the levels of these higher penalties for certain specified failures. Thus, the penalty for failure to report cash transactions that exceed $10,000 [2] is increased to 10 percent of the amount that should have been reported. Also, the penalty for failure to report exchanges of certain partnership interests or failure to report certain dispositions of donated property is 5 percent of the amount that should have been reported.

These provisions have generally been redrafted to improve their comprehensibility and administrability. In light of this redrafting, the bill repeals the existing penalty for failure to furnish an information return to the IRS (sec. 6652(a)) and the existing penalty for failure to supply a copy of the information return to the taxpayer (sec. 6678).

The bill also adds to the Code a new penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the taxpayer. This new penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or copy for the taxpayer, up to a maximum of $20,000 in any calendar year.

This new penalty does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect to that information return. Thus, if the person filing an information return is subject to a penalty under section 6676 for including an incorrect social security number on the information return, this new penalty is not imposed with respect to that information return.

This new penalty is intended to provide to persons filing information returns an incentive both to file accurate and complete information returns initially and to correct as rapidly as possible any incorrect information returns that may have been filed. If a person files what purports to be an information return, but which contains so many inaccuracies or omissions that the utility of the document

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[1] The bill also raises from $50,000 to $100,000 the maximum penalty for failure to supply taxpayer identification numbers (sec. 6676).

[2] *See* Code sec. 6050I.

is minimized or eliminated, the IRS may under circumstances such as these (as it does under present law) impose the penalty for failure to file an information return, rather than this new penalty for filing an information return that includes inaccurate or incomplete information.

As under present law, there is an exception from these penalties if the failure to file an information return with the IRS or to provide a copy to the taxpayer or to include correct information on either of those returns is due to reasonable cause and not to willful neglect. Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties. The bill retains the higher standards and special rules of present law that apply to failures with respect to interest or dividend returns or statements.

The bill also clarifies the provisions relating to furnishing a written statement to the taxpayer of a number of the substantive information reporting provisions of the Code. Under present law, a number of these provisions are technically effective only if the person required to supply the copy to the taxpayer has actually provided the information return to the IRS. These provisions have been redrafted so that the requirement to supply a copy of the information return to the taxpayer is triggered when there is an obligation to file (instead of the actual filing of) an information return with the IRS.

Effective Date

The provision is effective for information returns the due date of which (determined without regard to extensions) is after December 31, 1985.

2. Increase in Penalty for Failure to Pay Tax (Sec. 1302 of the bill and sec. 6651 of the Code)

Present Law

The Code provides that a taxpayer who fails to pay taxes when due must pay a penalty (sec. 6651(a)(2) and (3)). The penalty applies to a taxpayer who fails to pay taxes shown on the tax return. It also applies to a taxpayer who fails to pay taxes not shown on the tax return within 10 days of notice and demand for payment by the IRS. The penalty is one-half of one percent of the tax for the first month not paid, and increases by one-half of one percent for each month the failure to pay continues, up to a maximum of 25 percent.

This penalty can be abated if the failure is due to reasonable cause and not willful neglect. This penalty is not deductible for tax purposes.

Reasons for Change

The committee agrees with the President's proposal that it is appropriate that taxpayers who delay payment of properly owed taxes should pay penalties approximately equal to the overall cost of collecting these delinquent taxes. Thus, the cost of collecting

these delinquent taxes would in effect be borne by those who have delayed making payment, rather than by all taxpayers.

The committee believes that it is important that the penalty operate in a reasonably simple and generally uniform manner. Consequently, the committee does not adopt a cost of collection charge system, under which a taxpayer would be required to pay for the specific costs of the specific IRS actions required to collect the delinquent taxes from that taxpayer. Instead, the committee has maintained the general structure of the present law penalty for failure to pay taxes, but has increased the amount of the penalty once the IRS generally initiates more expensive collection methods.

Explanation of Provision

The bill modifies the penalty for failure to pay taxes that exists in present law by increasing in specified situations the amount of that penalty from one-half of one percent per month to one percent per month. This increase occurs after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. The IRS can do this in either of two ways. The most common method is that the IRS sends to the taxpayer a notice of intention to levy; this notice must be sent out at least 10 days before the levy occurs (sec. 6331(d)). In these circumstances, the increase in the penalty occurs at the start of the month following the month in which the 10-day period expires. The second method may be used when the IRS finds that the collection of the tax is in jeopardy. If this occurs, the IRS may make notice and demand for immediate payment of the tax, and, if the tax is not paid, the IRS may levy upon the assets of the taxpayer without regard to the 10-day requirement (sec. 6331(a)). Under this second method, the IRS makes notice and demand for immediate payment either in person or by mail. In these circumstances, the increase in the penalty occurs at the start of the month following the month in which notice and demand is made.

This increase in the rate of this penalty generally will occur after the IRS has made repeated efforts to contact the taxpayer by mail.[3] During the period that these initial mailings are made, the penalty for failure to pay taxes will remain at one-half of one percent. When the cycle of mailings is completed and the tax has not yet been paid, the IRS must switch to methods of collecting the tax that generally are much more expensive, such as telephoning or visiting the taxpayer. This is the point at which generally the penalty increases to one percent per month.

The bill also improves the coordination of the penalty for failure to pay taxes with the penalty for failure to file a tax return. Under present law, a taxpayer who does not file his tax return on time may be liable for a smaller total penalty (consisting of both the failure to file penalty and the failure to pay penalty) if the taxpayer never files a return than if the taxpayer files the return late. This occurs because the special rules of section 6651(c)(1)(B) in effect reduce the failure to pay penalty by the failure to file penal-

[3] Generally, the IRS sends taxpayers a series of four or five letters demanding payment before a levy is made. These letters will go out over a period of approximately six months. The IRS will, however, truncate the number of letters and the time between them for reasons such as concern that delay will jeopardize collection.

ty. The committee views this result as anomalous and, accordingly, repeals this special offset rule.

Effective Dates

The increase in the penalty for failure to pay taxes (as well as the repeal of the special coordination rule of section 6651(c)(1)(B)) is effective for amounts assessed after December 31, 1985, regardless of when the failure to pay began.

3. Negligence and Fraud Penalties (Sec. 1303 of the bill and sec. 6653 of the Code)

Present Law

Negligence

Taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one half the interest rate that taxpayers must pay on underpayments of tax multiplied against the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend payment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

The negligence penalty applies only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Taxpayers are also subject to a penalty if any part of an underpayment of tax is due to fraud (sec. 6653(b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. The first component is 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the

portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). The second component is an amount equal to one half the interest rate that taxpayers must pay on underpayments of tax, multiplied against the portion of the underpayment attributable to fraud, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). The burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)).

Reasons for Change

The committee is concerned that the negligence and fraud penalties have not been applied in a large number of cases where their application is fully justified. The committee has consequently modified several aspects of these penalties in order to improve their operation. In addition, however, the committee emphasizes that the IRS and the courts share significant responsibility to ensure that these penalties are fully asserted in appropriate instances.

In particular, the committee believes that the negligence penalty should apply to all taxes under the Code. The committee also believes that while the current special negligence penalty applicable to failure to include as income interest or dividends shown on an information return is appropriate, its scope is too narrow. The committee believes that, if a taxpayer is provided an information return with respect to an item that should appear on the taxpayer's tax return, but the taxpayer neglects to report that item, that taxpayer should be subject to a penalty. Consequently, the committee has expanded the scope of this special negligence penalty so that it applies (absent clear and convincing evidence to the contrary) to any item reported on an information return.

The committee is also concerned that the current applicability of the fraud penalty to the entire underpayment of tax (once the IRS has established fraud with respect to any portion of the underpayment) may decrease the efficacy of this penalty. The committee is concerned that imposing the same penalty on two taxpayers who have identical underpayments, one attributable wholly to fraud and the other attributable only in part to fraud, may be an insufficient deterrent to fraudulent behavior. Consequently, the committee has narrowed the scope of the fraud penalty so that it applies only to the portion of the underpayment attributable to fraud. The committee has concomitantly increased the level of the penalty. The committee believes that these modifications more appropriately target the fraud penalty to fraudulent behavior.

Explanation of Provision

Negligence

The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The bill includes within the scope of the definition of negligence both any failure to make a reasonable at-

tempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regulations. The bill does not, however, limit the definition of negligence to these items only. Thus, all behavior that is considered negligent under present law will remain within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The bill also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The bill expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns, described above (new sec. 6724(d)(1)). Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligence in the absence of clear and convincing evidence to the contrary. This 5 percent negligence penalty applies only to the portion of the underpayment attributable to the taxpayer's failure to report.[4]

Fraud

The bill modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the basic fraud penalty from 50 to 75 percent. (The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud. The bill does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the burden of proof shifts to the taxpayer to establish the portion of the underpayment that is not attributable to fraud. The committee believes that this rule is appropriate in that these facts are generally within the taxpayer's control. It is nonetheless the intention of the committee that the fraud penalty apply only to the portion of the underpayment attributable to fraud.

Interaction of negligence and fraud penalties

If an underpayment of tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which

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[4] This is determined at the top marginal rate applicable to the taxpayer. Thus, for example, consider a taxpayer who fails properly to report as income $1,000 that was reported on an information return as interest income and who also fails to report an additional $1,500 of income that is not reported on an information return. Assume that the top marginal rate from the income the taxpayer actually reported is 25 percent, but that after $1,500 of additional income, the taxpayer will be in the 35 percent bracket. The $1,000 of income that was reported on the information return is considered to be taxed in the 35 percent bracket. Thus, the penalty is $17.50 ($1,000 x .35 (tax rate) x .05 (penalty rate)).

generally applies to the entire underpayment of tax) does not apply to any portion of the underpayment with respect to which a fraud penalty is imposed.

Effective Date

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1985.

4. Revenue Effect of Penalty Provisions

These penalty provisions are estimated to increase fiscal year budget receipts by $360 million for 1986, $367 million for 1987, $377 million for 1988, $386 million for 1989, and $394 million for 1990.

B. Estimated Tax Payments by Individuals (Sec. 1311 of the bill and sec. 6654 of the Code)

Present Law

Individuals owing tax who do not make estimated tax payments are generally subject to a penalty (Code sec. 6654). In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

Reasons for Change

The committee believes that it is important for the proper functioning of the tax system that taxpayers be relatively current in paying their tax liability. In light of the fact that most taxpayers have taxes withheld from each paycheck and that wage withholding closely approximates tax liability [5] for many of these taxpayers, the committee believes that it is appropriate to require that taxpayers making estimated tax payments keep similarly current in their payments.

Explanation of Provision

The bill increases from 80 percent to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty. The alternate test of 100 percent of last year's liability remains unchanged.

Effective Date

This provision is effective with respect to taxable years beginning after December 31, 1985. Thus, the estimated tax payment due January 15, 1986, which is the final payment for taxable year 1985, is unaffected by this provision. All subsequent estimated tax payments are, however, subject to this provision.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $2,450 million for 1986, $220 million for 1987, $230 million for 1988, $235 million for 1989, and $240 million for 1990.

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[5] In fact, a number of these taxpayers are overwithheld. A substantial portion of overwithholding appears to occur because of taxpayer preference, however, rather than widespread defects in the withholding system.

C. Attorney's Fees and Exhaustion of Administrative Remedies

1. Award of Reasonable Litigation Costs Where Taxpayer Prevails and the Government Position Was Unreasonable (Sec. 1315 of the bill and sec. 7430 of the Code)

Present Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provides, in part, that in any civil action or proceeding brought by or on behalf of the United States to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court in its discretion may allow the prevailing party, other than the United States, reasonable attorney's fees as a part of the costs. This provision has limited applicability to tax litigation and resulted in very few attorney's fee awards, because the provision is limited to actions brought by or on behalf of the Federal Government (that is, to cases in which the taxpayer is the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Claims Court, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

In 1980, as part of Public Law 96-481, Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party, other than the United States, of fees and other expenses incurred by that party in any civil action (other than tort cases) brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applies, specifically, to cases in Federal district courts and the United States Claims Court. However, the provision is not applicable to cases in the United States Tax Court.[6]

Because this provision applies to cases in which taxpayers are plaintiffs, and not merely to cases brought by the Government, it creates a greater potential for fee awards in tax cases than did the Civil Rights Attorney's Fees Awards Act of 1976. The provision became effective on October 1, 1981. The provision repealed the applicability of the Civil Rights Attorney's Fees Awards Act of 1976 to tax litigation.

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[6] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court was established under Article I of the United States Constitution.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorneys' fees in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified.

In general, fees and expenses may be awarded under the Act only to individuals, corporations, and sole owners of businesses satisfying limitations on their net worth and their number of employees.

Damages assessable for instituting proceedings before the Tax Court merely for delay

Under present law, if it appears to the Tax Court that proceedings before it have been instituted or maintained by a taxpayer primarily for delay, or that the taxpayer's position in the proceedings is frivolous or groundless, then the court may award damages to the United States. Such damages cannot exceed $5,000 (Code sec. 6673).

Code section 7430

In general, Code sec. 7430 authorizes the award of reasonable litigation costs, including attorney's fees and court costs, to a taxpayer who prevails over the Federal Government in a tax case in any Federal court. Such costs may be awarded whether the action was brought by or against the taxpayer. No award may be made to the Government if the taxpayer does not prevail, or to any creditor of a prevailing taxpayer.

Section 7430 is the exclusive provision for awards of litigation costs in any action or proceeding to which it applies.

Reasonable litigation costs include expenditures, if reasonable in amount, for fees of the taxpayer's attorney or other representative, court costs, expenses of expert witnesses, and costs of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the taxpayer's case. The determination of what constitutes a reasonable amount of litigation costs is to be made by the court hearing the action or proceeding.

However, the amount that may be awarded for litigation costs in a particular proceeding (such as a Tax Court case) may not exceed $25,000. This limitation applies regardless of the number of parties to the proceeding or the number of tax years at issue. The net worth limitations applicable under the Equal Access to Justice Act are not applicable under section 7430.

Section 7430 authorizes an award of reasonable litigation costs only if the taxpayer establishes that the position of the Government in the case was unreasonable and the taxpayer has substantially prevailed with respect to the amount in controversy or the most significant issue or set of issues presented. The determination

by the court on this issue is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record.

No award may be made unless the court determines that the taxpayer had exhausted all administrative remedies available within the Internal Revenue Service.

Section 7430, which was enacted in the Tax Equity and Fiscal Responsibility Act of 1982, became effective for cases begun after February 28, 1983. Under present law, the provision does not apply to any proceeding commenced after December 31, 1985.

Reasons for Change

The committee believes that section 7430 has not been available long enough to provide comprehensive data on its operation and effectiveness. Further information is needed to confirm whether this mechanism is effective in deterring the Government from taking unreasonable positions in tax cases, as well as assisting taxpayers in vindicating their rights regardless of their economic circumstances. An extension without amendment of section 7430 will enable Congress to assess more completely whether this section is functioning as intended.

Also, a clarification must be made to provide for the funding of any awards under this section of the law. Specifically, awards will be payable in the case of Tax Court cases in the same manner as an award by a district court. Also, the Congress believes that if the tax litigation is the result of the arbitrary and capricious actions of an IRS employee, that employee should also be subject to sanctions.

Explanation of Provision

The bill provides for a 4-year extension of the awards of reasonable litigation costs, including attorneys' fees, under section 7430. Thus, that section applies to any proceeding commenced on or before December 31, 1989. Also, the bill provides that such awards in Tax Court cases are payable in the same manner as an award in a case before a district court.

Further, the bill requires the Secretary of the Treasury to submit a report within 90 days after the close of each calendar year beginning after 1985 and before 1990 to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. This report is to include (1) the number of awards made under Code section 7430 during such calendar year, (2) the number of proceedings in which claims for such awards were made by substantially prevailing parties during such calendar year, and (3) the aggregate amount payable by the United States pursuant to the awards so made during such calendar year.

Finally, the bill gives discretion to the court in tax cases to assess all or a portion of any award under section 7430 against the IRS employee if the court determines that the proceeding resulted from any arbitrary or capricious act of the employee. It is the intention of the committee that this provision apply to IRS attorneys, as well as non-attorneys. Thus, all employees of the Office of Chief Counsel of the IRS, such as those in the tax litigation function, are subject to this provision. This provision applies to them because they are responsible to the Chief Counsel of the IRS. It is irrele-

vant for purposes of this provision that the Chief Counsel of the IRS is responsible to the General Counsel of the Treasury rather than to the Commissioner of Internal Revenue. For purposes of this provision, all employees of the Chief Counsel of the IRS are considered IRS employees.

Effective Date

This provision applies to proceedings commenced after December 31, 1985 and on or before December 31, 1989.

Budget Effect

This provision is estimated to increase fiscal year budget outlays by a negligible amount.

2. Exhaustion of Administrative Remedies (sec. 1316 of the bill and new sec. 6710 of the Code)

Present Law

Under present law, taxpayers who are dissatisfied with proposed adjustments to their tax returns by the Examination personnel of the IRS can take their case immediately to the United States Tax Court rather than appeal administratively within the IRS.

Reasons for Change

The Tax Court inventory has risen dramatically over the past ten years. One factor contributing to this increase has been the practice of taxpayers petitioning their cases directly to the Tax Court without attempting to settle the dispute with the Appeals Division of the IRS. The Appeals Division has more authority to settle cases than the Examination Division of IRS does. Appeals regularly settles large numbers of cases based on the hazards of litigation. Many of the cases taken directly to the Tax Court are eventually settled by the Appeals Officers after the case has been opened in the Tax Court with little involvement by the Court.

The committee consequently believes that it is appropriate to provide a penalty for failure to exhaust administrative remedies. This new penalty will allow the Tax Court to penalize taxpayers who needlessly involve the Court in a dispute that should have been resolved in the Appeals Division of the IRS.

Explanation of Provision

The Tax Court is authorized to impose a penalty equal to $120 (twice the current filing fee) if it determines the taxpayer did not use reasonable efforts in good faith in attempting to resolve the case administratively. The taxpayer is considered to have met the requirements of this provision (and therefore not be subject to this penalty) in the following situations: he is only challenging an existing regulation or ruling (or a similar matter with respect to which Appeals has no authority to negotiate); he has attended one first level Appeals meeting; he cannot attend a first level Appeals meeting because it would be unduly burdensome; the IRS has waived the Appeals meeting; or the case has been in Appeals for six

months with no action. This new provision does not make exhaustion of administrative remedies a jurisdictional prerequisite to Tax Court review. This penalty is in addition to the original filing fee of the Tax Court. Exhaustion for purposes of this provision is not considered to be exhaustion for purposes of section 7430(b)(2) (relating to attorney's fees).

The committee also requires a joint annual report from the IRS and the Tax Court indicating the actions taken to deal with the increasing Tax Court inventory by closing cases more efficiently.

Effective Date

The exhaustion of administrative remedies penalty applies to cases filed with the Tax Court on or after January 1, 1987.

The annual report is due annually after 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by a negligible amount.

D. Tax Administration Provisions

1. Authority to Rescind Statutory Notice of Deficiency (sec. 1321 of the bill and sec. 6212 of the Code)

Present Law

Under present law, once the IRS has issued a statutory notice of deficiency (90-day letter), the IRS does not have the authority to withdraw the letter. The statutory notice is a jurisdictional prerequisite to petitioning the Tax Court for review of the IRS determination; the notice must be issued before the expiration of the statute of limitations. Once the notice has been issued, only a Tax Court decision can alter its effect.

Reasons for Change

In a number of cases, both the IRS and the taxpayer would prefer that the statutory notice be withdrawn so that the matter can be disposed of administratively without the involvement of the Tax Court. Therefore, the committee has determined that it is appropriate, where both the IRS and the taxpayer agree, to permit withdrawal of the statutory notice. This will permit the matter to be disposed of in the most efficient way.

Explanation of Provision

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed. Therefore, limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the parties are returned to the rights and obligations existing prior to the issuance of the withdrawn notice. Also, the IRS may issue a later notice for a deficiency greater or less than the amount in the rescinded notice.

Under Code section 7805, the Secretary has the authority to establish by regulation the procedures necessary to implement the withdrawal of notice provision to assure that the taxpayer has consented to the withdrawal of the statutory notice. The regulations should also clarify the effect of rescission on other provisions of the Code.

Effective Date

This provision is effective for statutory notices of deficiency issued on or after January 1, 1986.

2. Authority to Abate Interest Due to Errors or Delay by the IRS (sec. 1322 of the bill and sec. 6404 of the Code)

Present Law

Under present law, the IRS does not generally have the authority to abate interest charges where the additional interest has been caused by IRS errors and delays. This results from the IRS's long-established position that once tax liability is established, the amount of interest is merely a mathematical computation based on the rate of interest and due date of the return. Consequently, the interest portion of the amount owed to the Government cannot be reduced unless the underlying deficiency is reduced. The IRS does, however, have the authority to abate interest resulting from a mathematical error of an IRS employee who assists taxpayers in preparing their income tax returns (sec. 6404(d)).

Reasons for Change

In some cases, the IRS has admitted that its own errors or delays have caused taxpayers to incur additional interest charges. This may even occur after the underlying tax liability has been correctly adjusted by the IRS or admitted by the taxpayer. The committee believes that where an IRS official acting in his official capacity fails to perform a ministerial act, such as issuing either a statutory notice of deficiency or notice and demand for payment after all procedural and substantive preliminaries have been completed, authority should be available for the IRS to abate the interest independent of the underlying tax liability. The committee is especially concerned about IRS errors that cause taxpayers to receive much larger refunds than they are entitled to.

Explanation of Provision

In cases where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such delay. No aspect of the delay can be attributable to the taxpayer. The bill gives the IRS the authority to abate interest but does not mandate that it do so (except that the IRS must do so in cases of erroneous refunds of less than $1 million, described below). The committee does not intend that this provision be used routinely to avoid payment of interest; rather, it intends that the provision be utilized in instances where failure to abate interest would be widely perceived as grossly unfair. The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act.

The provision applies only to failures to perform ministerial acts that occur after the taxpayer has been contacted by the IRS. This provision does not therefore permit the abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an audit, regardless of the length of that time period. Similarly, if a taxpayer files a return but does not pay the taxes due, this provision would not permit abatement of

this interest regardless of how long the IRS took to contact the taxpayer and request payment.

The committee intends that the term "ministerial act" be limited to nondiscretionary acts where all of the preliminary prerequisites, such as conferencing and review by supervisors, have taken place. Thus, a ministerial act is a procedural action, not a decision in a substantive area of tax law. For example, an unreasonable delay in the issuance of a statutory notice of deficiency after the IRS and the taxpayer have completed efforts to resolve the matter would be grounds for abatement of interest.

Under its general authority to issue regulations, the IRS can issue regulations determining what constitutes a reasonable time for performing various ministerial acts called for by the Code.

The committee intends that the IRS exercise this authority to abate interest in instances in which it issues an erroneous refund check. For example, it has come to the committee's attention that the IRS may make an error that causes a taxpayer to get a refund check for $1,000 instead of the $100 that the taxpayer rightfully claimed. In the past, the IRS charged the taxpayer interest on the $900 for the time period that the taxpayer held that money.

The committee believes that it is inappropriate to charge taxpayers interest on money they temporarily have because the IRS has made an error. Consequently, the committee instructs the IRS not to charge interest on these erroneous refunds. The committee intends that two limitations be placed on this rule. First, it is not to apply in instances in which the taxpayer has caused the overstated refund to occur, such as by overstating a claim for a refund on a tax return. Second, it is not to apply to any erroneous refund checks that exceed $1 million.

Effective Date

This provision is effective for interest accruing with respect to deficiencies or payments for taxable years beginning in 1982. With respect to taxable years 1982, 1983, and 1984, the committee intends that taxpayers initiate a request that the IRS abate the interest and issue a refund. For taxable years following these years, the committee intends that the IRS offer on its own, in appropriate circumstances, to abate interest. Taxpayers may also request that the IRS abate interest.

3. Suspension of Compounding Where Interest on Deficiency Is Suspended (Sec. 1323 of the bill and sec. 6601 of the Code)

Present Law

Under present law, in the case of a deficiency in income, estate, gift, and certain excise taxes, a waiver of restrictions on assessment of the deficiency is filed when the IRS and the taxpayer agree on the proper amount of tax due at the conclusion of an audit. If, however, the Secretary fails to make notice and demand for payment within 30 days after the filing of the waiver, interest is not imposed on the deficiency from the 30th day after the waiver was filed until the date the notice and demand is issued. The provision does not, however, suspend the compounding of interest for the same period

on the interest which previously accrued on the underlying deficiency.

Reasons for Change

The intent of the present law provision is to suspend the running of interest where the IRS fails to issue the taxpayer a bill stating how much the taxpayer owes within 30 days of concluding an audit. The committee believes that it is appropriate to apply the same principle to the compounding of interest on previously accrued interest.

Explanation of Provision

Both the interest on the deficiency as well as the compounded interest on the previously accrued interest are suspended, starting 30 days after a taxpayer has filed a waiver of restrictions on assessment of the underlying taxes and ending when a notice and demand is issued to the taxpayer.

Effective Date

This provision is effective for interest accruing in taxable periods after December 31, 1985.

4. Exemption from Levy For Service-Connected Disability Payments (Sec. 1324 of the bill and sec. 6334 of the Code)

Present Law

Under present law, various payments, such as unemployment benefits, workmen's compensation, a minimum amount of ordinary wages, as well as certain pensions and annuities, are exempt from levy. This means the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other non-exempt sources available to the delinquent taxpayer.

Reasons for Change

The committee believes that various military service-connected disability payments should be exempt from levy, just as other similar payments are exempt from levy.

Explanation of Provision

The IRS is prohibited from levying on any amount payable to an individual as a service-connected disability benefit under specified provisions of Title 38 of the United States Code.

The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval or air service. The exemption covers direct compensation payments as well as other types of support payments for education and housing.

Effective Date

This provision is effective for payments made after January 1, 1986.

5. Modification of Administrative Rules Applicable to Forfeiture (Sec. 1325 of the bill and sec. 7325 of the Code)

Present Law

Under present law, the IRS can seize property that is used in violating the provisions of the Internal Revenue laws. If the amount of personal property seized is valued at $2500 or less, the IRS may use administrative procedures to forfeit the property and sell it without judicial action, after both appraisal and notice to potential claimants. A claimant may post a bond of $250 and require the Government to proceed by judicial action to sell the property. These procedures are separate and distinct from those the IRS uses for routine collection of past-due taxes.

Reasons for Change

The committee believes that the dollar values in this forfeiture provision are too low,[7] and should be raised to the levels that apply in Customs cases.[8] The committee believes that the administrative forfeiture procedures are more efficient than judicial ones and, where no claimants exist, will eliminate the unnecessary involvement of the judiciary. If a claimant exists, the committee continues to permit the claimant to require (after posting a bond) a judicial proceeding to implement the forfeiture.

Explanation of Provision

The bill allows the Treasury to administratively sell up to $100,000 of personal property used in violation of the Internal Revenue laws. Such sale would require both an appraisal to determine value and a notice by newspaper publication to potential claimants. Potential claimants can require a judicial forfeiture action by posting a $2500 bond.

Effective Date

This provision is effective on January 1, 1986.

6. Certain Recordkeeping Requirements (Sec. 1326 of the bill)

Present Law

In general, law enforcement officers are not subject to the substantiation rules of section 274(d) and the income and wage inclusion rules of section 132 for specified use of a law enforcement vehicle. The conference report on the repeal of the contemporaneous recordkeeping requirements for automobiles[9] provided that IRS

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[7] The $2,500 amount was last increased in 1958 (sec. 204 of the Excise Tax Technical Changes Act of 1958 (Pub. L. 85-859)); the $250 amount was in the Internal Revenue Code of 1954 as originally enacted.

[8] See 19 U.S.C. secs. 1607, 1608.

[9] H. Rept. 99-67 (May 7, 1985).

special agents are not to be included within the term "law enforcement officers."

Reasons for Change

The committee believes that it is appropriate to treat IRS special agents in the same manner as other law enforcement officers are treated.

Explanation of Provision

The bill provides that, for purposes of sections 132 and 274, use of an automobile by a special agent of the IRS is treated in the same manner as use of an automobile by an officer of any other law enforcement agency.

Effective Date

The provision is effective on date of enactment.

7. Revenue Effect of Tax Administration Provisions

These provisions are estimated to decrease fiscal year budget receipts by a negligible amount.

E. Interest Provisions

1. Differential Interest Rate (Sec. 1331 of the bill and sec. 6621 of the Code)

Present Law

Taxpayers must pay interest to the Treasury on underpayments of tax (Code sec. 6601). Interest generally accrues from the due date of the tax return (determined without regard to extensions). The Treasury must pay interest to taxpayers on overpayments of tax (sec. 6611). Both the rate taxpayers pay to the Treasury and the rate the Treasury pays to taxpayers are the same rate (sec. 6621). That rate is determined semi-annually for the 6-month period ending on September 30 and March 31. The adjusted rate takes effect on the following January 1 (for September 30 determinations) and July 1 (for March 31 determinations). The rate utilized is the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System. A special rate of 120 percent of the general rate applies to taxpayers who make substantial underpayments of tax attributable to tax-motivated transactions, such as tax shelters.

Reasons for Change

The committee is concerned that these interest provisions are not modeled sufficiently closely on other interest rates in the economy; this may have distortive effects. First, the committee is concerned that both the interest rate taxpayers pay the Treasury and the rate the Treasury pays to taxpayers are the same rate. Few financial institutions, commercial operations, or other entities, borrow and lend money at the same rate. Thus, either the rate taxpayers pay the Treasury or the rate the Treasury pays taxpayers is necessarily out of line with general interest rates in the economy. This distortion may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate. Consequently, the committee has approved a one-percent differential between these two interest rates.

Second, the committee is concerned that the prime rate, which is the basis for interest determinations under present law, is not as reflective of actual market rates involving transactions with the Government as other rates are. Consequently, the committee has based the interest rate on the three-month Treasury bill rate.

Explanation of Provision

The bill provides that the interest rate that Treasury pays to taxpayers is the three-month Treasury bill rate plus 2 percentage

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points. The bill also provides that the interest rate that taxpayers pay to the Treasury is the three-month Treasury bill rate plus 3 percentage points. The rate is rounded to the nearest full percentage.

The rate is adjusted quarterly. The rate is determined during the first month of a calendar quarter, and becomes effective for the following calendar quarter. Thus, for example, the rate that is determined during January is effective for the following April through June. This reduces by one month (from three months to two) the lag that exists in present law between the determination of the interest rate and the date it becomes effective.

The interest rate is determined by the Secretary based on the average market yield on outstanding three-month Treasury bills. This is parallel to the mechanism for determining Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for property and certain other obligations (see sec. 1274(d)).

Effective Date

This provision is effective for purpose of determining interest for periods after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $117 million for 1986, $314 million for 1987, $253 million for 1988, $219 million for 1989, and $547 million for 1990.

2. Interest on Accumulated Earnings Tax (Sec. 1332 of the bill and sec. 6601 of the Code)

Present Law

The accumulated earnings tax (sec. 531) is imposed to prevent corporations from accumulating (rather than distributing) income with the intent of reducing or avoiding taxes. Interest is charged only from the date the IRS demands payment of the tax, rather than the date the return was originally due to be filed.[10]

Reasons for Change

The committee believes that it is appropriate to impose interest on underpayments of the accumulated earnings tax in the same manner that interest is imposed for most other taxes in the Code. Consequently, interest is imposed under the bill from the date the return was originally due to be filed.

Explanation of Provision

The bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed.

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[10] See Rev. Rul. 72-324, 1972-1 C.B. 399.

Effective Date

This provision is effective for returns that are due (without regard to extensions) after December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by a negligible amount.

F. Modification of Withholding Schedules (Sec. 1335 of the bill and sec. 3402 of the Code)

Present Law

The Code requires that the Secretary prescribe tables and computational procedures for determining the appropriate amount of taxes to be deducted and withheld from wages (sec. 3402(a)). Form W-4 is the form on which that calculation is done. It is completed by the employee, who furnishes it to the employer.[11] The employer uses this form to determine the proper level of wage withholding. The employer does this by using tables issued by the Secretary that specify the proper amount of withholding, considering the employee's wage level and number of withholding allowances claimed.

The employee completes the Form W-4 by determining the proper number of withholding allowances (or exemptions) to which he is entitled. Withholding allowances may be claimed for the employee and any dependents (sec. 3402(f)) and for itemized deductions and estimated tax credits (sec. 3402(m)). Other items prescribed in regulations may also be claimed. For example, the regulations permit IRA contributions and the tax savings attributable to income averaging to be considered (see Treas. Reg. sec. 31.3402(m)-1). An employee's Form W-4 generally remains in effect until the employee revokes it and files a new one.

The IRS has authority to issue regulations permitting employees to request, once the amount of their withholding has been determined on the basis of Form W-4 and the withholding tables, that that amount of withholding be increased or decreased. The IRS has long permitted taxpayers to request increases in withholding; the IRS has never permitted taxpayers to request decreases in withholding.

Reasons for Change

Other provisions of the bill affect the wage withholding system in two ways. First, the bill alters several of the provisions of the Code relating to itemized deductions, tax credits, and other items that may be considered in computing withholding allowances. Forms W-4 that claim withholding allowances with respect to any of these altered provisions are inaccurate. For example, a Form W-4 that claims allowances for income averaging (which is repealed elsewhere in the bill) is inaccurate, in that it claims excessive allowances.

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[11] The employer is required to furnish copies of certain Forms W-4 to the IRS, such as those that claim more than 14 allowances or that claim total exemption from withholding (where wages are above $200 per week). Treas. Reg. sec. 31.3402(f)(2)-1(g). The IRS examines these forms, and if it determines that a claim of withholding allowances cannot be justified, it notifies the employer to change the employee's withholding.

Second, the bill affects the tables issued by the Secretary that are used by employers to determine the proper amount of withholding. The bill affects these tables primarily by altering the tax rates and brackets.

The committee has consequently determined that the wage withholding system needs to be modified.

Explanation of Provision

The bill requires that the IRS and Treasury modify the withholding schedules under section 3402 to better approximate tax liability under the amendments made by the bill. The committee expects that this modification will affect at least two major items. First, the committee expects that Form W-4 will be modified. Second, the committee expects that the withholding tables used by employers to determine the proper amount of wage withholding will also be modified.

With respect to modifying Form W-4, the committee expects that the IRS will make every effort to notify taxpayers that Form W-4 has been modified and that many taxpayers will need to file the modified form with their employers.

The modified form and tables should be designed so that withholding from taxpayer's wages approximates as closely as possible the taxpayer's ultimate tax liability. While the committee recognizes that it is impossible to accomplish this goal with absolute precision in the case of each taxpayer, it is nonetheless vital to the integrity of the tax system that the amount withheld from wages closely match the taxpayer's ultimate tax liability. While the committee recognizes that substantial involuntary overwithholding is undesirable,[12] the committee also recognizes that substantial underwithholding creates significant collection and enforcement problems.

While the committee believes that the changes in the substantive tax law made by this bill will permit wage withholding to approximate tax liability more closely for many taxpayers, the committee believes that increased complexity in the current Form W-4 and wage withholding tables is not desirable, even if it were designed to permit withholding to approximate tax liability more closely. Consequently, neither Form W-4 nor the wage withholding tables is to be made more complex when they are revised in accordance with this provision of the bill.

The bill also repeals the provision of present law giving the IRS authority to issue regulations permitting employees to request decreases in withholding. The provision relating to increases in withholding is unaffected.

Effective Date

The provision relating to modifications to the withholding forms and tables is effective for taxable years 1986 and following. The provision relating to decreases in withholding is effective on the date of enactment.

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[12] A significant portion of overwithholding appears to be attributable to taxpayer preference.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by a negligible amount.

G. Information Reporting Provisions

1. Information Reporting on Real Estate Transactions (Sec. 1341 of the bill and sec. 6045 of the Code)

Present Law

Brokers must, when required by Treasury regulations, file information returns on the business they transact for customers (sec. 6045). To date, the IRS has issued regulations requiring reporting only of gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals. Reporting on real estate transactions is not currently required under these regulations. The term "broker" is broadly defined as any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others (Treas. Reg. sec. 1.6045-1).

Reasons for Change

The committee is concerned that a sizeable number of real estate transactions that should be reported on tax returns are not being reported. Consequently, the committee has determined that it is appropriate to expand the current system of information reporting to include reporting on real estate transactions.

Explanation of Provision

The bill requires that real estate transactions be reported. The reporting is to be done by the settlement attorney or other stakeholder. This would generally be the person responsible for closing the transaction. Thus, in some localities the stakeholder could include either a title insurance company or a bank. If there is no stakeholder in a transaction, the reporting is to be done by the person designated in Treasury regulations. The committee anticipates that this reporting will be done on a Form 1099, similar to that required for other transactions effected by brokers. The committee also anticipates that the rules requiring that information returns from brokers be filed on magnetic media (see sec. 6011(e)) will encompass these information returns on real estate.

Effective Date

The provision is effective for real estate transactions occurring on or after January 1, 1986. Real estate transactions on or after that date must be reported without regard as to whether the IRS has issued regulations under section 6045(a) requiring that a return be filed. Thus, this provision (unlike the general broker reporting requirements of section 6045) is effective in the absence of implementing regulations.

2. Information Reporting on Persons Receiving Contracts from Certain Federal Agencies (Sec. 1342 of the bill and new sec. 6050M of the Code)

Present Law

There is no provision of present law that requires information reporting on persons receiving Federal contracts.

Reasons for Change

The committee is concerned that the dollar amount of taxes owed to the Federal Government that the IRS has attempted repeatedly to collect but cannot collect has grown in recent years to over $8.5 billion. The committee is also concerned that those who reap the benefits of Federal contracts also fulfill their Federal obligation of paying their taxes. Therefore, the committee has determined that it is appropriate to require information reporting from a Federal agency that enters into a contract. These information returns will notify the IRS of a source from which delinquent taxes may be collected, which will facilitate the collection of these delinquent taxes.

Explanation of Provision

The bill requires the head of Federal executive agencies to file an information return indicating the name, address, and taxpayer identification number (TIN) of each person with which the agency enters into a contract. The Secretary of Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the return useful as a source of information for collection purposes. Thus, it would be appropriate to require that these information returns be filed within a certain time period (such as 30 days) of signing the contract, rather than at the end of the calendar year. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts.

In some instances, several corporations, each with its own TIN, file one consolidated return. The Secretary has the authority to require that the information returns include the corporation's own TIN, as well as the TIN under which it files the consolidated return, so that the matching of Federal contracts with delinquent tax liability can be facilitated.

The new provision does not enlarge the collection procedures now available to the Service. Rather, these new returns will provide the IRS with a possible source of collection in the event taxes are unpaid.

Effective Date

This provision is effective on January 1, 1986. Thus, all contracts signed on or after that date are subject to information reporting. In addition, all contracts signed prior to that date are subject to information reporting if they are still in effect on that date.

3. Information Reporting on State and Local Taxes (Sec. 145 of the bill and sec. 6050E of the Code)

Present Law

Individual taxpayers who itemize deductions may deduct State and local income, real property, personal property, and sales taxes. There is no provision of present law that requires State and local governments to provide information reports to the IRS and the taxpayer on payments of State and local income, real property, and personal property taxes.

Reasons for Change

The committee is concerned that there is significant overstatement of claims of the itemized deduction for State and local taxes. The committee believes that it is appropriate to require information reporting of payments of these taxes, which will assist taxpayers and the IRS in ensuring that only State and local taxes actually paid are deducted.

Explanation of Provision

The bill requires that any State or local government that imposes an income tax, a real property tax, or a personal property tax, report to the individual who paid those taxes and to the IRS the amount of those taxes paid by that individual. These information reports must be filed in accordance with the timetable generally applicable to other information returns. Consequently, the copy for the taxpayer must be provided by the last day of January of the year following the year these taxes are paid; the State or local government has one additional month (until the end of February) to supply the information return to the IRS.

In order to reduce the burden on the State and local governments, the bill provides that no information return need be provided to the individual taxpayer if it is determined (in the manner provided under Treasury regulations) that that individual taxpayer does not itemize deductions.

Effective Date

The provision is effective on January 1, 1987. Thus, State and local governments will first provide information returns to individual taxpayers by the end of January 1988, and to the IRS by the end of February 1988, on taxes that were paid in 1987.

4. Tax-exempt Interest Required to be Shown on Tax Returns (Sec. 1343 of the bill and sec. 6012 of the Code)

Present Law

There is no requirement that all taxpayers report the amount of tax-exempt interest they receive on their tax returns. The individual income tax return (Form 1040) for 1985 does, however, require that taxpayers with taxable social security benefits report the tax-exempt interest they receive.

Reasons for Change

The committee believes that it is necessary, in order to calculate the correct taxable amount of social security and the correct amount of the minimum tax, to require that all taxpayers (whether individual, corporate, or other) report on their tax returns the tax-exempt interest they receive. This information will also be helpful in assuring that taxpayers comply with the provisions of section 265 (relating to the denial of a deduction for interest to purchase or carry tax-exempt obligations). The committee also believes that it will be beneficial to have this information available when it considers possible tax changes in the future.

Explanation of Provision

The bill requires that any person required to make a return of income under section 6012 include on that return the amount of tax-exempt interest received or accrued during the taxable year.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

5. Revenue Effect of Information Reporting Provisions

These information reporting provisions are estimated to increase fiscal year budget receipts by $43 million in 1986, $205 million in 1987, $444 million in 1988, $458 million in 1989, and $494 million in 1990.

H. Report on the Return-Free System and Miscellaneous Administrative Problems (Sec. 1345 of the bill)

Present Law

Taxpayers are generally required to file a paper document as their individual income tax return for the taxable year. These forms are currently the Form 1040 ("the long form"), the Form 1040A ("the short form"), and the recently created 1040EZ. In addition, the IRS is experimenting with magnetic tape return filing which allows approved return preparers to volunteer to file individual tax returns that they prepare with the IRS in a magnetic tape format. The return preparer retains the paper version of the tax return.

Reasons for Change

The ever-increasing paperwork burden on the Internal Revenue Service, the improved capabilities of computerized data processing, and expanded information reporting suggest that it may be possible to develop a return-free system for individuals. This system would relieve eligible taxpayers of most of the burden and expense of return preparation. Also, it would significantly reduce the volume of tax returns filed with the IRS. Consequently, the committee believes that it is appropriate to study the possibility of implementing the return-free system, which was first proposed in the President's proposal.

Explanation of Provision

The committee does not believe that the return-free system set forth in the President's proposal is sufficiently developed for implementation at this time. The committee therefore decided to require a report from the IRS setting forth:

(1) the identification of classes of individuals who would be permitted to use a return-free system;

(2) how such a system would be phased in;

(3) what additional resources the IRS would need to carry out such a system; and

(4) the types of changes to the Internal Revenue Code which would inhibit or enhance the use of such a system.

The report is to be submitted within six months of the date of enactment to the House Committee on Ways and Means and the Senate Committee on Finance.

In addition, the committee believes that the IRS should consider conducting an in-house feasibility test using previously filed information returns and individual income tax returns to test the practicality of the proposed system.

A number of provisions of this bill provide that the Secretary of the Treasury or his delegate is to prescribe regulations. Notwithstanding any of these references, it is contemplated that the Secretary or his delegate will, pending the prescribing of these regulations, issue guidance for taxpayers with respect to the changes made by this bill by issuing Revenue Procedures, Revenue Rulings, forms, or other publications.

The committee has also identified several miscellaneous administrative problems which should be corrected by the IRS to improve the present operation of the tax administration system.

The committee expects that the IRS will make every effort to improve the clarity of the notices and explanations sent to the taxpayers. Responses should be prepared in such a way that a taxpayer can understand the nature of any adjustments or penalties applied to a tax return as well as the nature of the obligation to pay any delinquent amounts, including interest.

Specifically, the committee believes that the following actions should be taken by the IRS:

(1) the IRS should change the balance due notice to clarify where and why estimated tax penalties apply;

(2) the IRS should explain other tax adjustments, penalty charges, or taxpayer errors on the adjustment notice to the taxpayer; and

(3) the IRS should advise taxpayers that a final tax payment notice assumes a certain payment date for purposes of calculating interest and that after that date additional interest will be due.

Effective Date

The report is due six months after enactment of the bill.

I. Collection of Diesel Fuel Excise Tax (Sec. 1351 of the bill and secs. 4041 and 6652 of the Code)

Present Law

An excise tax of 15 cents per gallon is imposed on the sale of diesel fuel for use in a diesel-powered highway vehicle (sec. 4041(a)(1)). The tax is imposed and collected at the retail level, and is scheduled to expire after September 30, 1988. Revenues from this tax are deposited in the Highway Trust Fund.

The excise tax (9 cents per gallon) on gasoline for highway vehicle use is imposed and collected at the manufacturer's level (sec. 4081).

Reasons for Change

Since there are many more retail outlets for diesel fuel sales than diesel fuel wholesalers, the committee concluded that allowing the tax to be imposed and collected by the wholesaler (or manufacturer for direct sales) upon the sale to the retailer will reduce the tax administrative burden on the numerous retail diesel fuel outlets and reduce the tax collection and enforcement costs to the Internal Revenue Service. Consequently, fewer taxpayers will be involved in filing excise tax returns.

Explanation of Provision

The bill provides that the excise tax on diesel fuel for highway vehicles may be imposed on the sale to the retailer by the wholesaler (jobber) or by the manufacturer where the sale is direct to the retailer.

This applies to the sale of diesel fuel to a "qualified retailer," defined as any retailer who (1) elects to have this provision apply with respect to all sales of diesel fuel to such retailer and (2) agrees to provide a written notice to whoever sells diesel fuel to such retailer that such an election has been made concerning application of the diesel fuel tax.

If a retailer required to notify the seller of diesel fuel fails to do so, the retailer is then liable for payment of the tax for the period for which the failure continues. Failure to provide the required written notice to the diesel fuel seller, unless shown to be due to reasonable cause and not to willful neglect, will result also in a penalty. This penalty is to be paid by the retailer with respect to each sale of diesel fuel to the retailer and is equal to 5 percent of the excise tax amount involved.

Effective Date

The provision applies to sales of diesel fuel (for use in highway vehicles) after the first calendar quarter beginning more than 60 days after the date of enactment.

Revenue Effect

This provision will increase net fiscal year budget receipts by $5 million in 1986, and by negligible amounts each year thereafter.

TITLE XIV—MISCELLANEOUS PROVISIONS

1. Exclusion From Gross Income for Certain Foster Care Payments (Sec. 1401 of the bill and sec. 131 of the Code)

Present Law

Under present law, a foster parent generally may exclude from income amounts paid as reimbursements for the expenses of caring for a foster child (under the age of 19) in the foster parent's home (Code sec. 131). To qualify for exclusion, the payments must be made by a State or political subdivision or by a State-licensed, tax-exempt child-placement agency. Also, the foster child must have been placed in the home by an agency of a State or political subdivision, or by a State-licensed, tax-exempt child-placement agency.

To implement the exclusion for reimbursements of foster care expenses, IRS requires foster parents to account for the expenses incurred for each foster child in their care. This accounting is required because any excess of foster care payments over actual expenses in the year is includible in gross income.

Reasons for Change

The committee believes that the current level of foster care payments closely approximates (or perhaps understates) the costs incurred in the care of foster children. The committee consequently believes that it is unnecessary to require foster parents to maintain detailed records of every expenditure in connection with each foster child as a condition for the exclusion to apply to foster care payments from State agencies or certain State-licensed child-placement agencies. The recordkeeping necessitated by present law requires prorating such expenses as housing and utility costs as well as expenditures for food. The committee believes that the requirement of such detailed and complex recordkeeping may deter families from accepting foster children or from claiming the full exclusion from income to which they are entitled.

Explanation of Provision

The bill modifies the exclusion for certain foster care reimbursements so that the exclusion applies to amounts paid for qualified foster care, rather than amounts paid as reimbursements of qualified foster care expenses. As a result, recordkeeping to establish the extent to which payments reimburse particular foster care expenses will not be necessary.

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

2. Reinstatement of Rules for Spouses of Vietnam MIA's (Sec. 1402 of the bill and secs. 2(a)(3)(B), 692(b), 6013(f)(1), and 7508(b) of the Code)

Present Law

In 1976, the Congress provided that four tax relief provisions applied to members of the U.S. Armed Forces listed as missing in action (MIA) in the Vietnam conflict.

The first provision, relating to the definition of a surviving spouse, stated that the date of death of a person in MIA status is the date of determination of death made by the Armed Forces under 37 U.S.C. secs. 555 and 556. The second provision exempted from Federal income tax the income of a member of the Armed Forces determined to have died while in MIA status, for the year in which the determination of death was made under 37 U.S.C. secs. 555 and 556 and any prior year which ends on or after the first day the member served in a combat zone. The third provision provided that the spouse of an individual in MIA status could elect to file a joint return. The fourth provision applied to the spouse of a member in MIA status the rule postponing the performing of certain acts by reason of service in a combat zone, including the filing of returns and the payment of taxes.

These relief provisions originally applied through 1978 in the case of Vietnam MIA's. However, for status determinations under 37 U.S.C. secs. 555 and 556 that were not completed, the provisions subsequently were extended through December 31, 1982.

Reasons for Change

The committee believes that these relief provisions should be retroactively reinstated with respect to Vietnam MIA's because of the continued need for such provisions.

Explanation of Provision

Under the bill, the tax relief provisions applicable with respect to Vietnam MIA's (and their spouses) that expired after 1982 are retroactively reinstated and made permanent.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

3. Olympic Trust Fund and Excise Tax on U.S. Television and Radio Olympic Broadcast Rights (Sec. 1403 of the bill and new secs. 4471-72 and 9505 of the Code)

Present Law

There is currently no excise tax on U.S. television or radio broadcast rights, nor is there any direct Federal funding of the U.S. Olympic Committee or team. Present law includes certain Federal excise taxes earmarked for various user or benefit-related trust funds.

The United States has entered into tax treaties with various countries. In some cases, these treaties provide limitations on the U.S. tax that can be imposed on payments to residents of the treaty country for the use of, or the right to use, copyrighted material and similar property.

Reasons for Change

The committee understands that Olympic teams from many other countries receive direct funding support from their governments, while the U.S. Olympic team does not. This requires the U.S. Olympic team to spend considerable time and expense in raising funds from various private sector sources. This time and expense could be used more productively to recruit and train U.S. Olympic-quality athletes on a continuing basis.

The committee also understands that in many foreign countries, the radio and television broadcast systems are owned by the government. By contrast, a number of networks compete for programming in the United States. As a result, unlike other foreign countries, the price bid for the right to broadcast Olymic events is a function of the competition which occurs between the networks. This competition, in effect, produces a windfall to the sponsors of Olympic events, whether held in the United States or some other country. The committee believes that the Olympic excise tax enacted by the bill will recoup a small portion of that windfall element, and that this result is equitable in view of the fact that the most significant component of the competitive bidding accrues to the sponsors of the Olympic games.

The committee determined that revenues attributable to such an excise tax should be dedicated to a trust fund for use by the U.S. Olympic Committee for development of training facilities and training expenses related to United States participation in Olympic events.

Explanation of Provision

Excise tax

The bill imposes a new 10-percent Federal excise tax on amounts paid for U.S. television and radio Olympic broadcast rights. The tax is imposed on the business or government receiving the payment; the payor of the amount is to withhold the tax from the amount of the payment for the broadcast rights and to pay over the withheld tax to the U.S. Government. "Broadcast rights" means any right (whether or not exclusive) to the original broad-

cast on television or radio in the United States of any summer or winter Olympic event.

The excise tax is to apply notwithstanding any U.S. treaty obligation, whether entered into before, on, or after the date of enactment of this provision. The excise tax is deductible for determining any Federal income tax liability.

Olympic Trust Fund

The bill establishes a new trust fund in the Treasury, designated the "United States Olympic Trust Fund," to receive amounts equivalent to the revenues from the new 10-percent excise tax discussed above. The Trust Fund also is to receive any interest earned on trust fund investments. The Trust Fund is to be managed by the Secretary of the Treasury. The Secretary is to make annual reports to the Congress on the financial status of the Trust Fund.

Available trust fund monies are to be paid by the Secretary, not less than quarterly, to the U.S. Olympic Committee, less any Treasury expenses in administering the tax and the Trust Fund. Trust fund monies can be used by the U.S. Olympic Committee for training facilities, coaches, and specific Olympic-development expenditure purposes.

Effective Date

The new excise tax generally is effective for amounts paid after November 22, 1985. However, the tax does not apply to amounts paid after that date pursuant to a binding contract that was in effect on that date and at all times thereafter. Thus, the new excise tax will not apply to the agreement of the National Broadcast Company (NBC) to purchase the television broadcast rights of the 1988 summer Olympic games nor will it apply to the agreement of the American Broadcast Company (ABC) to purchase the television broadcast rights of the 1988 winter Olympic games.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $10 million in 1989 and $15 million in 1990.

4. Exemption from Unrelated Business Income Tax for Rental of Mailing Lists and Certain Distributions of Low Cost Articles (Sec. 1404 of the bill and sec. 513 of the Code)

Present Law

General rules

Under present law, certain organizations are generally exempt from Federal income tax because of their charitable, educational, religious, or other nonprofit purposes and functions (Code sec. 501(c)(3)). However, a tax is imposed on the unrelated trade or business income of otherwise tax-exempt organizations (secs. 511-514). The tax applies to gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.

An unrelated trade or business is defined as any trade or business of a tax-exempt organization the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, religious, or other nonprofit purpose and function constituting the basis for its exemption (sec. 513(a)). Treasury regulations provide that the tax does not apply to income from an activity that does not possess the characteristics of a trade or business (within the meaning of sec. 162). For example, the regulations state, the tax does not apply where an organization "sends out low cost items incidental to the solicitation of charitable contributions" (Reg. sec. 1.513-1(b)).

Rental of mailing lists

The U.S. Court of Claims held in 1981 that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing lists constitutes unrelated business taxable income, and does not constitute "royalties" expressly exempted from the tax under section 512(b)(2) (*Disabled American Veterans* v. *U.S.*, 650 F.2d 1128 (1981)). The court found that in renting its donor lists, the DAV operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that these rental activities were regularly carried on; and that the rental activities were not substantially related to accomplishment of exempt purposes (apart from the organization's need for or use of funds derived from renting the mailing lists).

Reasons for Change

The committee believes that it is appropriate to specify the circumstances under which certain distributions of low cost articles incidental to soliciting charitable contributions are not treated as unrelated trade or business activities. In addition, the committee believes that the unrelated trade or business tax should not be imposed on income from exchanges or rentals of donor or member lists among tax-exempt organizations eligible to receive charitable contributions.

Explanation of Provisions

a. Rental of mailing lists

The bill provides that in the case of any organization exempt from tax under section 501 that is eligible to receive tax-deductible charitable contributions under section 170(c)(2) or 170(c)(3), the term unrelated trade or business does not include any trade or business of such organization that consists of exchanging names and addresses of donors to (or members of) such organization with another such tax-exempt organization, or of renting donor (or member) names and addresses to another such tax-exempt organization.

b. Distribution of low cost articles

The bill provides that in the case of any organization exempt from tax under section 501 that is eligible to receive tax-deductible charitable contributions under section 170(c)(2) or 170(c)(3), the term unrelated trade or business does not include activities of such organization relating to the distribution of low cost articles incidental to the solicitation of charitable contributions.

For this purpose, an article is low cost if it has a cost not in excess of $5 to the organization which distributes such item (or on whose behalf such item is distributed). Beginning in 1987, this dollar limitation is indexed for inflation as provided in the bill. If more than one item is distributed by or on behalf of an organization to a single distributee in any calendar year, the aggregate of the items so distributed in the year to such distributee is treated as one article for purposes of the dollar limitation.

A distribution of low cost articles qualifies under the bill only if—

(1) the distribution is not made at the request of the distributee;

(2) the distribution is made without the express consent of the distributee; and

(3) the articles distributed are accompanied by a request for a charitable contribution to such organization, and also by a statement that the distributee may retain the low cost article regardless of whether the distributee makes a charitable contribution to such organization.

Effective Date

These provisions apply to distributions of low cost articles and exchanges and rentals of membership lists occurring after the date of the enactment of the bill.

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by $4 million in 1986, $7 million in 1987, $8 million in 1988, $9 million in 1989, and $11 million in 1990.

5. Allocation of Housing Cooperative Interest and Taxes (Sec. 1405 of the bill and sec. 216 of the Code)

Present Law

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent such amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative, paid or incurred by the cooperative with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc. of the cooperative's buildings. The tenant-stockholder's proportionate share is that portion of the cooperative's interest and taxes that bears the

same ratio to the cooperative's total expenses for interest and taxes that the portion of the cooperative's stock held by the tenant-stockholder bears to the total outstanding stock of the cooperative.

In general, a cooperative housing corporation is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on a complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders. A tenant-stockholder generally is an individual owning fully paid up stock in the cooperative corporation, the purchase price of which bears a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

Reasons for Change

The committee believes that the proportionate share rule pursuant to which a housing cooperative's expenses for interest and taxes are allocated among tenant-stockholders may create inequitable results in at least three situations.

The first situation is where a housing cooperative issues equal numbers of shares to all tenant-stockholders regardless of the relative values of the dwelling that each such tenant-stockholder is entitled to occupy (usually to provide each tenant-stockholder with an equal say in matters of corporate governance), but the periodic charges payable to the cooperative by each of the tenant-stockholders reflect the differing values of, or the differing costs associated with their respective dwellings. In this case, the proportionate share rule would allocate equal amounts of interest and taxes to each tenant-stockholder notwithstanding the unequal portions thereof borne by such tenant-stockholders.

The second situation is where a tenant-stockholder prepays all or a portion of the housing cooperative's indebtedness allocable to the tenant-stockholder's dwelling unit and the periodic charges payable to the cooperative by such tenant-stockholder are reduced commensurately with the reduction in the cooperative's debt service. Here, the proportionate share rule would not take into account the reduction in the amount of interest paid by the cooperative attributable to that particular tenant-stockholder (which may be zero after a complete prepayment).

The third situation is where the housing cooperative is located in a jurisdiction that separately assesses the dwelling units in a cooperative for real estate tax purposes, and the periodic charges payable by each tenant-stockholder directly reflect such separate assessments. Here, the proportionate share rule would allocate the cooperative's taxes among the tenant-stockholders proporationately with their stockholdings, ignoring the differing portions of such taxes borne by such tenant-stockholders.

The committee believes that the proportionate share rule may not achieve the proper income tax consequences in these and ana-

lagous situations and believes that the rule should be modified to account properly for such situations.

Explanation of Provision

Under the bill, where a housing cooperative charges each tenant-stockholder with a portion of the cooperative's interest and taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes attributable to such tenant-stockholder's dwelling unit, then the cooperative may make an election whereby the share of the cooperative's interest and taxes that each tenant-stockholder is permitted to deduct would be the amounts that were so separately allocated and charged.

The committee intends that this provision is to be availed of in circumstances that will result in an allocation of the cooperative's interest and taxes that more accurately reflects the relative burdens of such items borne by respective tenant-stockholders. The requirement that the allocation reasonably reflect the cost to the cooperative of the interest and taxes attributable to the tenant-stockholder's dwelling unit is intended to assure that a cooperative may not allocate deductible expenses of the cooperative to those tenant-stockholders for whom the deductions would be most valuable, and the non-deductible expenses of the cooperative to those tenant-stockholders for whom the deductions would be less valuable.

Thus, taxes allocated to a tenant-stockholder's unit will be considered to reasonably reflect the cost of the cooperative if the taxes allocated are based on the amounts separately assessed by the taxing authority. In the case of indebtedness of the cooperative incurred to purchase property, interest allocated to a tenant-stockhoder's unit will be considered to reasonably reflect the cost to the cooperative if the amount allocated is based on the cooperative's purchase price of the property, allocated in accordance with the fair market value of the units purchased (including the unit's share of common areas).

Effective Date

The provision is effective for taxable years beginning after December 31, 1985.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

6. Treatment of Computer Software Royalties and Interest of Securities Dealers for Purposes of the Personal Holding Company Tax (Sec. 1406 of the bill and sec. 543 of the Code)

Present Law

Under present law, a corporation that is treated as a "personal holding company" is subject, in addition to the regular corporate tax, to a 50 percent tax on its "undistributed personal holding company income" for the taxable year. Generally, a personal holding company is a corporation at least 50 percent of the value of whose

stock is held by not more than five individuals, and at least 60 percent of whose adjusted ordinary gross income is "personal holding company income" (sec. 542(b)). For the purpose of the stock ownership test, an individual is treated as owning the stock owned directly or indirectly by or for any family members or partners of the individual and also is treated as owning a proportionate share of stock owned by corporations or partnerships in which the individual is a stockholder or partner (sec. 544).

Personal holding company income generally includes passive-type income such as interest, dividends, and certain rents and royalties (sec. 543(a)). Exceptions are provided for certain rents and royalties where the corporation derives most of its income from such rents or royalties, has only limited amounts of other personal holding company income (or distributes most of such income), and incurs deductible expenses in amounts that reflect active business activity rather than the mere collection of passive income. Royalties relating to the use of computer software are not eligible for any of such exceptions.

Certain corporations are excepted from the definition of personal holding company. The excepted corporations include tax-exempt organizations, banks, domestic building and loan associations, life insurance companies, surety companies, foreign personal holding companies, lending or finance companies that meet certain active business or gross income tests, foreign corporations with no U.S. shareholders, small business investment companies licensed by the Small Business Administration, and corporations subject to the jurisdiction of the Bankrupcy Court (sec. 542(c)).

Reasons for Change

Since the present law rules defining personal holding company income make no exceptions for any royalty income derived from the licensing of computer software, it is possible that a closely held corporation that is engaged in extensive business activities relating to the development and distribution of computer software would be subject to the personal holding company tax unless it distributes its income to shareholders. The committee believes that it is inappropriate to apply the personal holding company tax in this situation and that an exception to the definition of personal holding company income analagous to those provided for rent and certain other types of royalties should be provided.

Further, the committee believes that the definition of personal holding company income, insofar as it generally includes all gross income from securities, does not properly measure the personal holding company income of certain dealers in securities who derive certain income from securities held as inventory or who engage in certain lending transactions. In such lending transactions, the corporation borrows amounts and simultaneously relends such amounts on terms virtually identical to the corporation's borrowing. The corporation profits from a small difference in the amount of interest that it receives and interest that it pays on these "matched" loans. In these circumstances, the committee believes that the corporation's "spread" is the proper measure of interest income with respect to these transactions. Moreover, the committee

believes that certain income derived from securities held in the dealer's inventory should not be included in personal holding company income.

Explanation of Provisions

Computer software royalties

Overview

Under the committee bill, certain royalties relating to computer software are not treated as personal holding company income. To qualify for this treatment the recipient must (a) be actively engaged in the trade or business of producing, developing, or manufacturing computer software, (b) derive more than half of its income from software royalties, (c) incur substantial trade or business expenses, or research and development expenses, and (d) distribute most of its passive income other than software royalties.

Active business requirements

Under the committee bill, personal holding company income does not include certain computer software royalties. To qualify for the exception, four conditions must be met.

First, computer software royalties must be received by a corporation engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software; such computer software (a) must be developed, manufactured, or produced by such corporation (or its predecessor) in connection with such trade or business, or (b) must be directly related to such trade or business (the "trade or business test"). For this purpose, predecessor includes a partnership, the partners of which developed software for the partnership and transferred their partnership interests to the corporation in exchange for substantially all of the corporation's stock.

Second, computer software royalties that meet the first requirement must make up at least 50 percent of the ordinary gross income (as defined in section 543(b)) of the taxpayer for the taxable year (the "50-percent test").

Third, the amount of expenses that are properly allocable to the active business of developing, producing, or manufacturing software and that are allowable to the taxpayer under section 162 (relating to trade or business expenses), section 174 (relating to research and development expenses), or section 195 (relating to amortization of start-up expenses), must equal or exceed 25 percent of the ordinary gross income of the taxpayer for the taxable year (the "25-percent test").[1] Alternatively, the average of such deductions for the period of five taxable years ending with the current taxable year (or such shorter period as the corporation may have been in existence) must equal or exceed 25 percent of the ordinary gross income of the taxpayer for such period.

In computing deductions under section 162, the taxpayer may not take into account payments for personal services rendered by

[1] For purposes of this computation, any deduction specifically allowable under any section of the Code other than section 162 may not be treated as allowable under section 162.

the five shareholders holding the largest percentage (by value) of the outstanding stock of the corporation. In determining the five largest shareholders for this purpose, stock deemed to be owned by a shareholder solely by reason of attribution from a partner (under section 544(a)(2)) is not taken into account, and individuals holding less than five percent of the corporation's stock (by value) are not taken into account.

Fourth, the sum of dividends paid during the taxable year (under section 562), dividends considered paid on the last day of the taxable year (under section 563) and the consent dividends for the taxable year (under section 565) must equal or exceed the amount of the corporation's personal holding company income in excess of 10 percent of the ordinary gross income of the corporation. For purposes of this computation, however, personal holding company income does not include the computer software royalties taken into account for the 50-percent test, and also does not include interest income for the five-year period beginning with the commencement of the active computer software business, provided that the 50-percent test and the 25-percent test also are met in this period.

Special rule for affiliated groups

Under the committee bill, a special rule is provided in the case of computer software royalty income received by a member of an affiliated group. The bill provides that if a taxpayer who is a member of an affiliated group (within the meaning of section 1504(a)) receives royalties in connection with the licensing of computer software, and another member of the group meets the trade or business test, the 50-percent test, and the 25-percent test with respect to such software, then the taxpayer is treated as having met such requirements.

Dealers in securities

Overview

Under the committee bill, certain securities dealers are permitted to exclude from personal holding company income certain income received on securities or money market instruments held in inventory. To qualify for this treatment, the taxpayer must be a dealer in securities that (a) derives at least 50 percent of its income from the active conduct of the business of dealing in securities, (b) distributes most of its passive income not derived from the business of dealing in securities, and (c) incurs substantial trade or business expenses relating to the business of dealing in securities.

The committee bill also provides that dealers in securities may deduct interest expense on certain offsetting loans in computing their interest income for purposes of the personal holding company provisions.

Income from inventory

Under the committee bill, personal holding company income does not include certain income of a dealer in securities from securities or money market instruments held as inventory if certain requirements are met. There are four conditions to qualify for the exception.

First, the taxpayer must be a dealer in securities.[2]

Second, the sum of income of the taxpayer from the trade or business of dealing in securities (other than personal holding company income) and the excepted income of such dealer from securities or money market instruments held as inventory must equal or exceed 50 percent of the taxpayer's ordinary gross income.

Third, the sum of dividends paid during the taxable year (under section 562), dividends considered paid on the last day of the taxable year (under section 563) and the consent dividends for the taxable year (under section 565) must equal or exceed the amount of the corporation's personal holding company income in excess of 10 percent of the ordinary gross income of the corporation. For purposes of this computation, however, personal holding company income does not include the excepted income on the securities or money market instruments held as inventory.

Fourth, the sum of the deductions allowable to the taxpayer under section 162 must equal or exceed 15 percent of the taxpayer's ordinary gross income. For this purpose, payments for compensation for personal services rendered by any shareholder and deductions that are specifically allowable under any section other than section 162, are not treated as deductions allowable under section 162.

Reduction in interest income from offsetting loans

Under the committee bill, a dealer in securities that regularly derives income from transactions involving "offsetting loans" may, for purposes of the personal holding company rules, reduce the interest income from such transactions by the related interest expense.

For this purpose, a loan is treated as offsetting another loan if such loan (a) made at the same time as such loan, (b) is in substantially the same amount as such loan, (c) has the same maturity as such loan, (d) is secured by the same property as such loan, and (e) is designated in such manner as the Secretary of the Treasury may prescribe as an offfsetting loan. The committee intends that so-called "repurchase" transactions that are treated as loans for Federal income tax purposes may qualify as offsetting loans under the provision if all of the conditions are met.[3]

Effective Date

The provision is effective for royalties and interest received after December 31, 1985, in taxable years ending after that date.

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[2] The committee intends that for purposes of this provision, the term securities includes money market instruments.

[3] For example, if a dealer in securities purchases securities subject to an obligation of the seller to repurchase such securities, and at the same time (e.g., the same day) the dealer resells the securities for the same amount subject to an obligation to repurchase, if both transactions are treated as loans for Federal income tax purposes, then the two transactions may qualify as offsetting loans if the original seller is required to repurchase the securities at the same time and on substantially the same terms and that the dealer is required to repurchase the securities from the second buyer, with the difference in such terms reflecting the dealer's interest "spread."

Revenue Effect

The provision is expected to decrease fiscal year budget receipts by $4 million in 1986, and $10 million annually thereafter.

7. Adoption Assistance Program of the Social Security Act (Sec. 1407 of the bill and sec. 473(a) of the Social Security Act)

Present Law

Under present law, an itemized deduction is allowed for up to $1,500 of adoption expenses paid or incurred for the legal adoption of a child with special needs (Code sec. 222). Deductible expenses include reasonable and necessary adoption fees, court costs, and attorney fees.

The criteria in the Adoption Assistance Program authorized under Title IV-E of the Social Security Act and used by the States in defining a child with special needs are used in determining whether a taxpayer can claim an adoption expense deduction related to the adoption of a particular child. While such children must meet the criteria as a child with special needs, they do not have to be AFDC, AFDC foster care, or SSI disabled children for the adoptive parents to claim the adoption expense deduction as is the case under the Title IV-E Adoption Assistance Program.

Reasons for Change

In view of the committee decision to repeal the present adoption expense tax deduction (see description above of sec. 134 of the bill), the committee agreed to provide Federal matching funds to States to pay for certain adoption expenses related to the legal adoption of a special needs child. The benefits of the Adoption Assistance Program can be more efficiently directed to those who need financial assistance in such adoption cases, whereas the deduction for adoption expenses gives relatively more benefit to higher income taxpayers and no benefit to nonitemizers.

Explanation of Provision

The Adoption Assistance Program under Title IV-E of the Social Security Act is amended to provide 50-percent Federal matching funds to States to pay for "nonrecurring adoption expenses" related to the adoption of a special needs child. The expenses for which a State could claim Federal matching funds are those expenses defined as "qualified adoption expenses" in Code section 222, as presently in effect.

Under the bill, the committee intends that assistance will be provided under the Title IV-E Adoption Assistance Program to adoptive parents who adopt children with special needs and who would have been eligible to claim an adoption expense deduction under the present tax law. This includes adoptive parents of all special needs children placed according to State and local law and is not limited to those adoptive parents of special needs children who are eligible under the present Title IV-E program, i.e., those who adopt a AFDC, AFDC foster care, or SSI disabled or blind child.

While the bill extends assistance for nonrecurring adoption expenses to adoptive parents of all special needs children, the present program of monthly adoption assistance payments will remain limited to those who adopt AFDC, AFDC foster care, or SSI children. To ensure continued assistance to those adoptive parents who adopt children with special needs, and who would have been eligible to claim an adoption expense deduction under present tax law, the committee intends that close working relationships between the public and private adoption agencies should be established.

Under the bill, the State Title IV-E Adoption Assistance agency is to make arrangements with the licensed private adoption agencies in the State whereby adoptive parents can, by way of the private agency, be reimbursed for some or all of the costs which, under present law, the parents could claim as a qualified adoption expense deduction. In addition to reimbursement of the adoptive parents through the private adoption agencies, States should also be encouraged to have purchase of service agreements in place so that all or a part of the adoption fees normally charged to the adoptive parents could be paid for on behalf of the adoptive parents directly by the State Title IV-E agency. Those arrangements or agreements would be for the purpose of ensuring that expenses incurred by or on behalf of the adoptive parents be treated the same as if the adoption activities were provided by the public adoption agency.

The present tax code provision on adoption expenses establishes a cap ($1,500) on eligible deductions. The current Title IV-E statute also allows a State to establish limits under adoption assistance agreements on the amount of recurring monthly adoption assistance payments to be provided to adoptive parents. This general authority for a State to set limits on the amount of assistance to be provided to adoptive parents will also apply under the bill to "nonrecurring" adoption expenses. However, the amount of the assistance will not be limited, as is now the case for monthly adoption assistance, to the amount that would have been paid for foster care. In other words, as under present adoption assistance agreements, a State may set limits on the amount of the expenses to be financed by the State and the amount may vary among adoptive parents depending on the circumstances of the parents and the child.

Effective Date

The provision applies with respect to expenditures made after December 31, 1985. If after that date an individual receives a payment of nonrecurring adoption expenses pursuant to the provision, no deduction is allowable for such expenses under Code section 222.

Budget Effect

This provision is estimated to increase budget outlays by amounts comparable to the amounts of increased budget receipts resulting from repeal of the itemized deduction for certain adoption expenses (see description above of sec. 134 of the bill).

TITLE XV—TECHNICAL CORRECTIONS PROVISIONS

The technical corrections title contains clerical, conforming and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, which was part of the Deficit Reduction Act of 1984 (P.L. 98-369), the Retirement Equity Act of 1984 (P.L. 98-397), and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment.

These provisions are treated as enacted immediately before the other provisions of this Act.

TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984

A. Technical Corrections to Tax Freeze and Tax Reform Provisions

1. Tax Freeze Items

a. Finance lease rules (sec. 1501(a) of the bill and sec. 12(c) of the Act)

Present Law

Under the finance lease rules, the fact that a lessee has a fixed-price purchase option or the leased property is limited use property is not taken into account in determining whether the agreement is a lease. The Tax Reform Act of 1984[1] ("The Act") postponed the effective date of the finance lease rule, except for property acquired pursuant to a binding contract entered into before March 7, 1984, and certain other property.

Explanation of Provision

Under the bill, taxpayers can elect to have the amendment that defers the finance lease rules apply to any agreement entered into before March 7, 1984.

b. Telephone excise tax (sec. 1501(b) of the bill and sec. 4251 of the Code)

Present Law

The Act extended the three-percent telephone excise tax through December 31, 1987. Due to a clerical error in enrolling the Act, the year 1985 was inadvertently deleted.

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[1] Division A of the Deficit Reduction Act of 1984 (Public Law 98-369).

Explanation of Provision

The bill restores the year 1985 to the table of years for which the three-percent telephone excise tax applies.

c. Electronic funds transfer for alcohol and tobacco excise taxes (sec. 1501(c) of the bill and secs. 5061 and 5703 of the Code)

Present Law

The Act requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar year to pay that tax by electronic funds transfer during the succeeding calendar year.

Explanation of Provision

The bill clarifies that all corporations that are members of a controlled group of corporations are treated as one person for purposes of the electronic funds transfer requirement. The term controlled group of corporations has the same meaning as under Code section 1563, except a 50-percent, rather than an 80-percent, common ownership test is applied. It is understood that the Treasury Department administratively will apply this 50-percent common ownership requirement only with respect to taxes due after March 28, 1985.

Additionally, Treasury Department authority to apply these principles to a group of persons under common control where some members of the group are not corporations is clarified.

2. Tax-Exempt Entity Leasing

a. Treatment of use in unrelated trade or business (sec. 1502(a)(1) of the bill and sec. 168(j)(3)(D) of the Code)

Present Law

In the case of 19-year real property, the Act defines "tax-exempt use property" as the portion of property that is leased to tax-exempt entities under disqualified leases. This definition applies only if the portion of the property leased in a disqualified lease is more than 35 percent of the property. The Act also provides that the term "tax-exempt use property" does not include any portion of a property that is used predominantly in a tax-exempt entity's unrelated trade or business.

Explanation of Provision

The bill clarifies that the portion of a property that is used in a tax-exempt entity's unrelated trade or business is not treated as used pursuant to a disqualified lease. For example, assume that a tax-exempt entity leases 100 percent of a building for a term of 21 years. Eighty percent of the building is used in the tax-exempt entity's unrelated trade or business, and 20 percent is used in its exempt function. No portion of the building constitutes tax-exempt use property because the portion used in a disqualified lease (20 percent) is less than 35 percent of the property.

b. Treatment of certain previously tax-exempt organizations (sec. 1502(a)(2) of the bill and secs. 168(j)(4)(E) and (9) of the Code)

Present Law

Under the Act, the term "tax-exempt entity" includes any organization (other than certain farmers' cooperatives) that was exempt from U.S. income tax at any time during the five-year period ending on the date the property involved is leased to such organization (or any successor organization engaged in substantially similar activities).

Explanation of Provision

The bill clarifies that the rule for former tax-exempt organizations is not limited to property that is leased to such organizations; the rule applies with respect to any property other than property owned by a former tax-exempt entity or a successor organization. Under the bill, the five-year period ends on the date the property involved is "first used" by a former tax-exempt entity. Property is treated as first used by an organization (a) when the property is first placed in service under a lease to such organization, or (b) in the case of property owned by a partnership (or other pass-through entity) of which the organization is a member, the later of the day on which the property is first used by the partnership (or other pass-through entity) or the day on which the organization is first a member of such partnership (or other pass-through entity).

For purposes of the rules relating to property owned by a partnership, any "tax-exempt controlled entity" is treated as a tax-exempt entity. The term "tax-exempt controlled entity" is defined as any corporation that is not a tax-exempt entity if 50 percent or more (by value) of the corporation's stock is held directly or (by application of section 318) indirectly by one or more tax-exempt entities. In applying section 318, the rules relating to attribution from a corporation are to be applied without regard to the 50-percent test. Therefore, an entity will be treated as owning its proportionate share of stock held by a corporation in which the entity has a direct ownership interest, regardless of the entity's ownership percentage. For example, assume that each of three unrelated tax-exempt entities utilizes a wholly owned taxable subsidiary to invest in one-third of the stock of a fourth taxable corporation. The fourth taxable corporation acquires an interest in a partnership holding depreciable property. Under section 318(a)(2)(C), each tax-exempt entity would be treated as owning one-third of the stock in the fourth taxable corporation. Therefore, the fourth taxable corporation would constitute a tax-exempt controlled entity. Because the rules for attribution from a corporation are applied without the 50-percent threshold, the same result would obtain if the three unrelated tax-exempt entities invested in one-third of the stock of a single taxable corporation, and the taxable corporation organized a second taxable corporation; here, the second taxable corporation would constitute a tax-exempt controlled entity.

A tax-exempt controlled entity is not treated as a tax-exempt entity (or as a successor to a tax-exempt entity) if an election is

made to treat any gain recognized by a tax-exempt entity on disposition of an interest in the tax-exempt controlled entity (as well as any dividends or interest received or accrued from the tax-exempt controlled entity) as unrelated business taxable income under section 511. The election binds all tax-exempt entities holding interests in the tax-exempt controlled entity.

The amendment relating to tax-exempt controlled entities applies to property placed in service after September 27, 1985, except property acquired pursuant to a written contract that was binding on that date and at all times thereafter. A tax-exempt controlled entity can elect to have the amendments apply to property placed in service on or before September 27, 1985.

The bill also clarifies that the Federal Home Loan Mortgage Corporation is not treated as a tax-exempt entity.

c. Repeal of overlapping regulatory authority (sec. 1502(a)(3) of the bill and sec. 168(j)(5)(C)(iv) of the Code)

Present Law

The Act authorized the Treasury to determine whether any high-technology telephone station equipment or medical equipment is subject to rapid obsolescence. The Act also provides that the Treasury is to prescribe any other regulations that may be necessary or appropriate to carry out the purposes of section 168(j) (sec. 168(j)(10)).

Explanation of Provision

The bill repeals the overlapping regulatory authority relating to high-technology equipment.

d. Partnership rules (sec. 1502(a)(4) of the bill and secs. 168(j)(8)–(9) and 48(a)(5) of the Code)

Present Law

The Act provides that sections 168(j)(8) (relating to property leased to a partnership) and 168(j)(9) (relating to property owned by a partnership) apply for purposes of paragraphs (4) and (5) of section 48(a) (relating to the nontaxable use restriction on investment credits).

Explanation of Provision

The bill clarifies the manner in which the partnership rules in section 168(j) apply for purposes of the investment credit provisions. Any portion of a property that is treated as tax-exempt use property by application of paragraph (8) or (9) of section 168(j) is excluded from the definition of section 38 property under paragraphs (4) and (5) of section 48.

e. Treatment of certain aircraft leased to foreign persons (sec. 1502(a)(5) of the bill and secs. 47(a) and 48(a) of the Code)

Present Law

Section 47(a)(7) provides an exception to the investment credit recapture rules for certain leases of aircraft for use predominantly outside the United States. This exception applies if, *inter alia*, an aircraft that qualified for the credit in the taxable year in which it was placed in service would otherwise cease to qualify as section 38 property because it is used predominantly outside the United States.

Under the Act, generally, property that is leased for a term of less than six months qualifies as section 38 property, even if the lease is to a foreign person or entity. In the case of aircraft that is leased to a foreign person before January 1, 1990, and is used under a lease that qualifies for treatment under section 47(a)(7), investment credits are not recaptured if the term of such lease does not exceed three years.

Explanation of Provision

The bill clarifies that the short-term lease exception for aircraft is intended to permit the operation of section 47(a)(7), where property would otherwise cease to qualify as section 38 property because it is leased to a foreign person for use predominantly outside the United States, and not to provide an exception to the definition of section 38 property. The application of this provision is illustrated by the following example. Assume an aircraft is placed in service by a U.S. air carrier on January 1, 1986, and is used for the entire taxable year solely in the United States. On January 1, 1987, the aircraft is leased to a foreign person for use predominantly outside the United States, under a "qualifying lease" (within the meaning of section 47(a)(7)). The term of the lease is two years. Because of the application of new section 47(a)(9), as well as section 47(a)(7), no investment credit is recaptured. If such aircraft is disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person. In the example above, at the end of the two-year lease term, although the U.S. air carrier has actually owned the aircraft for three years, the taxpayer is considered to have used the plane for only one year for purposes of the recapture rules.

f. Section 593 organizations (sec. 1502(a)(6) and (8) of the bill and sec. 46(e)(4) of the Code)

Present Law

Under the Act, the lessor of property to a section 593 organization (or "thrift institution") is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property. The Act also provides rules designed to prevent taxpayers from circumventing the rules with respect to leased property by use of certain arrangements,

other than service contracts but including partnerships, under which a thrift institution obtains the use of property.

Explanation of Provision

The bill clarifies present law by expressly providing that a thrift institution cannot avoid the restriction on property leased to a section 593 organization by use of a partnership.

The bill also clarifies that the tax credit for rehabilitation expenditures is allowable on buildings leased to section 593 organizations in accordance with the rules applicable to buildings leased to tax-exempt entities.

g. Treatment of certain property held by partnerships (sec. 1502(a)(7) of the bill and sec. 168(j)(9) of the Code)

Present Law

If a tax-exempt entity's share of partnership items would be treated as income or loss from an unrelated trade or business under section 511, then the partnership's property will not be treated as tax-exempt use property.

Explanation of Provision

The bill clarifies that the determination of whether a tax-exempt partner's share of partnership items is treated as derived from an unrelated trade or business is to be made without regard to the debt-financed income rules of section 514.

h. Treatment of service contracts (sec. 1502(a)(9)(C) of the bill and sec. 7701(e) of the Code)

Present Law

Section 7701(e) provides rules for use in determining whether an arrangement structured as a service contract is more properly treated as a lease.

Explanation of Provision

Section 7701(e)(4) is amended by adding a cross reference to the definition of "related entity" in section 168(j).

i. Effective date provisions (sec. 1502(a)(10) of the bill)

(1) Section 31(g)(3)(B) of the Act is amended to clarify that transitional relief is provided only from the application of section 168(j)(9) (as added by the Act).

(2) Section 31(g)(4) of the Act is amended to clarify that certain credit unions qualify for transitional relief, that governmental action before Mary 23, 1984 qualifies a successor plan for the Greenville, South Carolina, Coliseum, and that certain actions taken with respect to the Essex County, New Jersey, Courthouse qualify as significant governmental action.

(3) Effective for property placed in service by the taxpayer after July 18, 1984, section 31(g)(15)(D) of the Act is amended to clarify

that the transitional rule for certain aircraft applies to aircraft originally placed in service after May 23, 1983.

(4) Section 31(g)(17)(H) is amended to clarify that, in the case of Clemson University, the term "property" includes only the Continuing Education Center and component housing projects.

(5) Section 31(g)(20)(B)(ii) of the Act, which provides that improvements to property that qualify for transitional relief also qualify for relief unless the improvement is a substantial improvement, is amended to clarify that the substantial-improvement exception to the rule applies to personal property, as well as real property. This amendment will not apply to personal property if there was a binding written contract to acquire, construct, or rehabilitate the property (or if construction, reconstruction, or rehabilitation of the property began) on or before March 28, 1985.

3. Bonds and Other Debt Instruments

a. Treatment of amounts received on disposition of short-term obligations (sec. 1503(a)(1) and (2) of the bill and sec. 1271 of the Code)

Present Law

Section 1271 expressly provides that any gain realized on disposition of governmental short-term obligations is treated as ordinary income, to the extent of the ratable share of accrued acquisition discount. Long-standing judicial authority and Treasury regulations provide a basis for characterizing accrued original issue discount (OID) as ordinary income on disposition of nongovernmental obligations.

Explanation of Provision

The bill clarifies the treatment of amounts received on disposition of nongovernmental obligations. Under a general rule, any gain realized on disposition of a short-term nongovernmental obligation is treated as ordinary income to the extent of the ratable share of accrued OID. Taxpayers may elect to accrue OID with respect to a short-term nongovernmental obligation under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the issue price of the obligation, compounded daily. A similar election is provided for the computation of acquisition discount with respect to short-term governmental obligations. An election to account for discount under an economic accrual formula cannot be revoked without the consent of the Secretary.

b. Treatment of deduction of OID on short-term obligations (sec. 1503(a)(4) of the bill and sec. 163(e) of the Code)

Present Law

In general, interest on a debt instrument with a maturity of one year or less which is payable at the maturity of the instrument is not deductible by a cash-method issuer until paid. *See* Treas. Reg. sec. 1.1232-3(b)(1)(iii) (providing that such interest is not included

in the "stated redemption price at maturity" for purposes of section 1232, the predecessor of section 1273).

Explanation of Provision

The bill clarifies present law by expressly providing in section 163(e) that an issuer of a short-term debt instrument may deduct original issue discount and any other interest only in the year of payment. A similar provision was included in the Conference Report to the Act. That provision was deleted in House Concurrent Resolution 328 (June 29, 1984) because it was deemed to be a mere restatement of preexisting law.

It is understood that some taxpayers have interpreted the deletion of this provision from the Concurrent Resolution as evidencing an intent to modify the prior-law proscription against deduction of interest on an accrual basis by cash-method issuers of short-term obligations. The purpose of this amendment is to clarify that no such result was intended.

c. Treatment of certain transfers of market discount bonds (sec. 1503(a)(5) of the bill and sec. 1276(d) of the Code)

Present Law

Under the Act, an obligation issued in an exchange subject to section 351 (which provides nonrecognition treatment where appreciated property is transferred to an 80-percent owned corporation in exchange for stock or securities of the corporation) may fall within the definition of the term "market discount bond," without regard to whether the property transferred is a market discount bond (see the discussion of present law, below). Thus, taxpayers are prevented from circumventing the rule that characterizes accrued market discount as interest by swapping a market discount bond for a new bond in a section 351 exchange. A different result may obtain, however, where a taxpayer swaps a market discount bond for stock in a section 351 exchange.

Explanation of Provision

The bill clarifies that taxpayers are prevented from circumventing the market discount provisions by transferring a bond with accrued market discount in a section 351 exchange. Under the bill, accrued market discount is taxed to the transferor of a market discount bond in a section 351 exchange, regardless of whether the transferor receives stock or securities in the exchange. The corporate transferee of the market discount bond will take the bond with a basis that reflects any gain recognized to the transferor (sec. 362(a)). If the stated redemption price of the bond exceeds the transferee's basis immediately after acquisition, then the bond will constitute a market discount bond in the hands of the transferee.

d. Treatment of bonds acquired at original issue for purposes of market discount rules (sec. 1503(a)(6) of the bill and sec. 1278(a) of the Code)

Present Law

Because market discount is defined as any excess of stated redemption price over basis (excluding OID), it is arguable that market discount is created on issuance of obligations in certain nonrecognition (or nontaxable) exchanges. An example is provided by the application of the statutory definition to a bond issued in a section 351 exchange. Under section 358, the basis of a bond received in a section 351 exchange is determined by reference to the basis of the property transferred in exchange for the bond (in the hands of the transferor). Thus, the stated redemption price of the bond will exceed its basis to the extent of any appreciation in the transferred property. Assuming no OID, this excess could be viewed as market discount.

The Act provides that the rule that characterizes accrued market discount as interest on disposition of a bond is inapplicable to bonds issued on or before July 18, 1984. If a pre-enactment bond is exchanged for a newly issued bond in a tax-free transaction, however, the new bond is subject to the interest characterization rule, even if the holder of the bond essentially maintains the original investment.

Explanation of Provision

The bill clarifies that, except as provided by statute or by regulation, no market discount is created on the original issuance of a bond.

Under the bill, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at "wholesale" prices (at deeper discounts than those available to "retail" customers). Under the bill, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder's issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (*e.g.*, in a recapitalization). Solely for purposes of the interest characterization rule, however, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

If the adjusted basis of a bond is determined by reference to the adjusted basis of the bond in the hands of a person who acquired the bond at original issue, the bond will be treated as acquired by the taxpayer at its original issue.

e. Treatment of certain stripped bonds or stripped coupons (sec. 1503(a)(7) of the bill and sec. 1281(b) of the Code)

Present Law

The Act requires the current inclusion in income of OID or acquisition discount with respect to short-term obligations held by certain taxpayers. This provision was intended to limit the scope of the rules that permit deferral to the ordinary investor.

Explanation of Provision

The bill requires the current inclusion in income of OID with respect to stripped bonds and stripped coupons held by the taxpayer who stripped the bond or coupon (or any other person whose basis is determined by reference to the basis in the hands of the stripper).

f. Accrual of interest on certain short-term obligations (sec. 1503(a)(8) of the bill and sec. 1281(a) of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or OID on a short-term obligation that is allocable to the portion of the taxable year during which the taxpayer held the obligation. Acquisition discount is defined as the excess of the stated redemption price at maturity over the taxpayer's basis in the obligation. Similarly, OID is defined as the excess of the stated redemption price at maturity over the issue price of the obligation. The taxpayers affected are those for whom the cash method of accounting for interest income from short-term obligations is considered inappropriate.

Explanation of Provision

The bill clarifies that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest allocable to that year with respect to short-term obligations, irrespective of whether the interest is stated or is in the form of acquisition discount or OID, and irrespective of when any stated interest is paid. For example, a calendar-year taxpayer designated in section 1281(b) holds an obligation from the time it is issued on October 1, 1985 until its maturity on October 1, 1986. Under the bill, the taxpayer is required to include in income for 1985 the equivalent of three months interest on the obligation, regardless of whether the interest income is in the form of acquisition discount, OID, stated interest, or any combination thereof.

The provision will apply to obligations acquired after September 27, 1985.

g. Treatment of debt instruments issued for property where there is public trading (sec. 1503(a)(10) of the bill and sec. 1273(b) of the Code)

Present Law

Under section 1273(b) of the Code, if a debt instrument is issued for property and either the debt instrument is traded on an established securities market or the property for which it is issued is stock or securities which are traded on an established securities market, the issue price of the instrument is the fair market value of the property.

Explanation of Provision

The bill permits the Secretary to designate in regulations other types of publicly traded property which for purposes of the issue price provisions will be treated like publicly traded stock or securities.

h. Amortization of bond premium (sec. 1503(a)(11) of the bill and sec. 171 of the Code)

Present Law

If a taxable bond is purchased at a premium (i.e., at a price that exceeds the redemption price), the holder may elect to amortize the bond premium over the term of the bond (sec. 171). Amortizable bond premium is allowed as an ordinary deduction. In computing amortizable bond premium, taxpayers are permitted to use a straight-line method. For purposes of these rules, the term "bond" is defined to exclude bonds issued by individuals. An election to amortize bond premium is effective for all bonds held or acquired at or after the beginning of the first taxable year for which the election is made.

Explanation of Provision

The bill conforms the treatment of bond premium to the treatment of bond discount: bond premium is to be computed under a constant yield method. Amortizable bond premium is computed on the basis of the taxpayer's yield to maturity, determined by using the taxpayer's basis for the bond, and compounding at the close of each "accrual period" (as defined in section 1271(a)(5)). The bill also extends section 171 to obligations issued by individuals.

The provisions will apply to obligations issued after September 27, 1985. For taxpayers who have elections in effect as of the date of enactment, such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

i. Clarification of transitional rule (sec. 1503(b)(1) of the bill and sec. 44 of the Act)

Present Law

Section 44(b) of the Act (relating to effective dates), as amended by section 2 of Public Law 98-612, provides special test and imputation rates under sections 1274 and 483 for certain transactions occurring before July 1, 1985.

Explanation of Provision

The bill clarifies that the effective date for new section 1274 and section 483 as amended by the Act—transactions after December 31, 1984—is not accelerated by section 2 of Public Law 98-612.

j. Clarification of interest accrual with respect to transactions involving adequate stated interest (sec. 1503(b)(2) and (3) of the bill and sec. 44(b)(3) of the Act)

Present Law

Section 44(b)(3)(A)(i)(I) of the Act provides that, after March 1, 1984, and before January 1, 1985 (the date on which new section 483 becomes effective), the unstated interest allocable to a taxable year must be computed on an economic accrual basis. Section 44(b)(3)(A)(i)(II) proscribes the accrual of interest on a noneconomic basis with respect to debt instruments issued in a sale or exchange after June 8, 1984, and before January 1, 1985, where there is adequate stated interest for purposes of section 483. The Act contains an exception for transactions pursuant to binding contracts in effect on March 1, 1984.

Explanation of Provision

The bill clarifies that, in the case of debt instruments issued for property in transactions occurring after December 31, 1984, whether involving adequate stated interest or inadequate stated interest, interest may not be computed using any method other than economic accrual, as described in Rev. Rul. 83-84, 1983-1 C.B. 9.

The bill also changes the binding contract date applicable to transactions involving adequate stated interest. The exception to the statutory requirement of economic accrual is made applicable to transactions occurring pursuant to a written contract that was binding on June 8, 1984 and at all times thereafter until the transaction was closed. No inference is intended regarding the proper treatment (under other provisions of the Code, or under general tax law principles) of noneconomic accruals of interest with respect to obligations issued before the effective date of the Act.

k. Clarification of effective date for repeal of capital asset requirement (sec. 1503(b)(5) of the bill and sec. 44(g) of the Act)

Present Law

Section 44(g) of the Act provides that (section 1272 (relating to the current inclusion of original issue discount) does not apply to

any obligation issued before December 31, 1984, for obligations that are not capital assets in the hands of the holder.

Explanation of Provision

The bill clarifies that section 1272 does not apply to obligations issued on or before December 31, 1984, for obligations that are not capital assets in the hands of the holder.

4. Corporate Provisions

a. Debt-financed portfolio stock (sec. 1504(a) of the bill and sec. 246A of the Code)

Present Law

The Act added a provision generally limiting the dividends received deduction for dividends received by a corporate shareholder with respect to debt-financed portfolio stock.

Explanation of Provision

The bill clarifies the rules for applying the provision in cases in which dividends are received from certain foreign corporations engaged in business in the United States. For example, assume that 70 percent of a domestic corporation's purchase price for portfolio stock of a foreign corporation described in section 245(a) is debt financed. Assume further that 60 percent of that foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States. In the absence of section 246A, the domestic corporation generally would be entitled to deduct 51 percent (85 percent times 60 percent) of any dividend received from the foreign corporation. Under section 246A and the bill, the domestic corporation generally is entitled to deduct only 15.3 percent ((30 percent times 85 percent) times 60 percent) of any such dividend.

b. Holding period rules for dividend received deduction (sec. 1504(b)(1) of the bill and sec. 246(c) of the Code)

Present Law

Under present law, as amended by the Act, a corporation must hold stock for 45 days (90 days in the case of certain preference dividends) in order to obtain a dividend received deduction with respect to any dividend on that stock. Days more than 45 days after the ex-dividend date and days on which the corporation's risk of loss is diminished are not taken into account. Under these rules, it can thus be determined on the 45th day after the ex-dividend date whether or not the holding period requirement will be met. However, present law disallows the deduction only if the stock has been disposed of by the corporation. Thus, present law may retroactively deny the dividends received deduction when the corporation disposes of the stock. This may require filing amended returns in some cases and in other cases the period of limitations may expire.

Explanation of Provision

The bill disallows the dividend received deduction where the holding period requirement is not met, without regard to whether the stock has been disposed of. Thus, where the holding period requirement has not been met on the 45th day (90th day in the case of certain preference dividends) after the ex-dividend date, the dividend received deduction will not be allowed. The amendment is not intended to require, for example, that the holding period be met by the date the dividend is received where the stock was acquired less than 45 days before that date, provided the stock is held for 45 days or more. No inference is intended as to the proper interpretation of present law.

The provision will apply to obligations acquired after the date of enactment of this Act.

In addition, the committee wishes to clarify that the 1984 Act did not change the principle that the dividend received deduction is not disallowed by reason of an out-of-the money call option that affords the corporation no protection against loss in the event the stock declines in value. See Revenue Ruling 80–238, 1980–2 C.B. 96.

c. Application of related party rule to section 265(2) of the Code (section 1504(b)(2) of the bill and section 53(e) of the Act).

Present Law

Section 265(2) of the Code disallows the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers.

The Act (Code sec. 7701(f)) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (i) the linking of borrowing to investment, or (ii) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. This provision was specifically intended to apply to (but not to be limited to) the disallowance rule provided by sections 265(2).

Under the Act, the provision regarding related persons, pass-through entities, and other intermediaries was effective on the date of enactment (July 18, 1984).

Explanation of Provision

Under the bill, the provision regarding related parties, pass-through entities, and other intermediaries generally remains effective as of July 18, 1984 (i.e., the date of enactment). However, the bill clarifies that this provision, insofar as it relates to section 265(2) of the Code only, is effective for (1) term loans made after July 18, 1984, and (2) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984). "Demand loans" mean any loan which is payable in full at any time on the demand of the lender. For purposes of this effective date rule, any loan renegotiated, extended, or revised after July 18, 1984, is treated as a loan made after such date.

d. Exempt-interest dividends from regulated investment companies (sec. 1504(c) of the bill and sec. 852 of the Code)

Present Law

Prior to the Act, a taxpayer could convert short-term capital gain into long-term capital gain by buying stock of a regulated investment company (or real estate investment trust) immediately before the ex-dividend date of a long-term capital gain distribution, receiving that distribution, waiting 32 days, and then selling the stock. The Act made conversion of this type more difficult. However, a problem similar to the long-term capital gain distribution problem that existed before the Act remains with respect to exempt-interest dividends received from a regulated investment company. Under present law, a taxpayer can buy stock of a regulated investment company immediately before the ex-dividend date of an exempt-interest dividend, receive that dividend, wait 32 days, and then sell the stock. Any loss on the sale generally is recognized.

Explanation of Provision

Under the bill, if a taxpayer holds stock of a regulated investment company for 6 months or less, any loss on the sale or exchange of that stock is disallowed to the extent the taxpayer received exempt-interest dividends with respect to that stock. Conforming amendments are made, and an exception is provided for dispositions pursuant to a periodic liquidation plan.

In addition, the Secretary is given authority to shorten the 6 months requirement to a period of not less than the greater of 31 days or the period between regular dividend distributions where the RIC regularly distributes at least 90 percent of its net tax-exempt interest. The distribution period is to be shortened only where the purpose of the holding period requirement can be adequately fulfilled without requiring that the stock be held 6 months.

The provision applies to stock with respect to which the taxpayer's holding period begins after March 28, 1985.

e. Accumulated earnings tax (sec. 1504(d) of the bill and sec. 562 of the Code)

Present Law

Prior to the Act, individual taxpayers attempted to convert dividend income into capital gains through the use of non-RIC investment companies which received dividend income (which was eligible for a dividends received deduction) and did not distribute that income to their individual shareholders. In order to prevent this result, the Act clarified that these corporations were subject to the accumulated earnings tax. However, it may still be possible to avoid dividend treatment through the use of stock redemptions, whereby the shareholder receives capital gains treatment and the investment company is relieved of the accumulated earnings tax (sec. 562(b)(1)).

Explanation of Provision

The bill provides that, except to the extent provided by the Secretary of the Treasury, no dividends paid deduction will be allowed, for purposes of the accumulated earnings tax, in the case of any stock redemption by a mere holding or investment company which is not a regulated investment company. The bill will apply to redemptions after September 27, 1985.

f. Definition of affiliated group (sec. 1504(e)(1) and (6) of the bill and sec. 1504 of the Code)

Present Law

The Act substantially revised the definition of "affiliated group". To apply the new rules, a determination must be made as to the ownership of "stock" of a corporation. Under the Act and section 1504(a)(4), "stock" does not include stock which, among other things, has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par values).

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation has to be an "includible corporation". Under section 1504, certain corporations do not qualify as includible corporations. Thus, for example, a former DISC is not an includible corporation. Nor is a subsidiary of a former DISC. Under prior law, the accumulated DISC income of a former DISC was included in the gross income of its shareholders, as a dividend. over a period of up to 10 years. If the former DISC and its parent could file a consolidated return, the former DISC's accumulated DISC would go untaxed, i.e., the parent would eliminate the "dividend" under Treas. regs. sec. 1.1502-14.

The Act substantially revised the rules relating to DISCs and former DISCs. Under the new rules, there is less reason to keep a former DISC and its parent from filing consolidated returns. Furthermore, if a former DISC is not treated as an includible corporation, its parent may be able to selectively deconsolidate subsidiaries.

Explanation of Provision

Section 1504(a)(4) is amended to exclude stock which has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). The amendment makes irrelevant the accounting treatment given the issuance of the stock.

Under the bill, any DISC or any other corporation that has accumulated DISC income derived after 1984 will not be an includible corporation. It is intended that this provision will not affect the status of certain S corporations with DISC subsidiaries who were "grandfathered" by the Subchapter S Revision Act of 1982.

g. Effective date of affiliated group provision (sec. 1504(e)(2), (3), (4), and (5) of the bill and sec. 60 of the Act)

Present Law

The Act substantially revised the definition of "affiliated group". The provision was generally effective for taxable years beginning after December 31, 1984. However, section 60(b)(2) of the Act provided a grandfather rule with respect to any corporation which on June 22, 1984, was a member of an affiliated group filing a consolidated return for such corporation's taxable year which includes June 22, 1984—for purposes of determining whether such corporation continues to be a member of such group for taxable years beginning before January 1, 1988, the provision does not apply. Under section 60(b)(3) of the Act, the grandfather rule described in the preceding sentence does not apply once a "sell-down" with respect to the corporation involved has occurred.

Explanation of Provision

The bill makes several technical changes with respect to the effective date rules.

First, the grandfather rule ceases to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under prior law. Thus, for example, a corporation which ceased to be a member of a group on July 31, 1985, under prior law but which on July 31, 1985 (and thereafter), qualifies as a member of the group under the Act's substantive rule is treated as continuing to be a member of the group.

Second, the bill amends section 60(b)(3) of the Act to clarify the "sell-down" exception to the grandfather rule. Thus, the exception does not apply, and the grandfather rule continues to apply, if the percentage interest (by fair market value) in the stock of the corporation involved held by other members of the group (determined without regard to section 60(b)(3) of the Act) does not decline as a result of the sale, exchange, or redemption of such corporation's stock. Also, the bill provides that the "sell down" exception applies in certain cases where there is a letter of intent between a corporation and securities underwriter entered into on or before June 22, 1984.

Third, the bill allows a common parent corporation to elect to have this provision apply to taxable years beginning after December 31, 1983.

Finally, the bill delays the effective date for one specified corporation until the earlier of January 1, 1994, or the date on which the voting power of certain preferred stock terminates, and exempts one specified corporation from the new rules.

h. Complete liquidations of subsidiaries, etc. (sec. 1504(e)(6) and (7) of the bill and secs. 332, 337 and 338 of the Code)

Present Law

Prior to the Act, the rules applicable in determining whether a corporation qualified as a corporation which could be liquidated under section 332 were substantially similar to the general rules

applicable in determining whether that corporation was a member of an affiliated group under section 1504. The Act substantially amended the general rules of section 1504 but not those of section 332. As a result, there is now discontinuity between the two sections. Thus, a corporation might be liquidated tax free under section 332 even though it and its "parent" are not members of the same affiliated group under new section 1504. The converse is also true. This discontinuity may produce unacceptable tax consequences.

For example, assume that beginning on January 1, 1985, P Corporation's ownership of S Corporation satisfies new section 1504 but not present-law section 332 and that, under new section 1504, P and S file consolidated returns for the 1985 calendar year. Assume further that (1) S adopts a plan of complete liquidation in 1985, then sells all its assets, and then liquidates within 12 months from the date the plan is adopted, and (2) P does not liquidate. Because S's liquidation does not qualify under section 332, S may be able to avail itself of section 337 (sec 337(c)(2)). That result is appropriate so long as P is taxed on S's liquidation, as would in general be the result given the inapplicability of section 332. However, since P and S file a consolidated return, S's liquidation would not be taxable to P under Treas. regs. sec. 1.1502-14(b) (assuming S distributes no cash to P in the liquidation). Therefore, S could dispose of all its assets and liquidate, with neither P nor S incurring any current tax liability.

As a further example, assume that (1) J Corporation's ownership of K Corporation stock satisfies present-law section 332 but not new section 1504, and (2) the two corporations are not filing a consolidated return under section 60(b)(2) of the Act for their 1985 calendar year. Assume further that K adopts a plan of complete liquidation, on January 1, 1985, then sells all its assets, and then liquidates within 12 months. Under section 332, the liquidation would not be taxable to J. Furthermore, it would appear that, since J and K are not in a new section 1504(a)(2) relationship, K may be able to avail itself of section 337 (sec. 337(c)(3)). Again, K could dispose of its assets and liquidate, with neither J nor K incurring any tax liability. (On the other hand, if J and K were filing consolidated returns under section 60(b)(2) of the Act, K could not avail itself of section 337 unless J timely liquidated. J would be a "distributee corporation" under section 337(c)(3)(B) since new section 1504 would not yet apply.)

Explanation of Provision

The bill amends section 332. Section 332 will not apply unless, among other things, the corporation receiving the liquidating distribution was, on the date of the adoption of the plan of liquidation and continued to be at all times until receipt of the liquidating distributions, the owner of stock in the liquidating corporation meeting the requirements of new section 1504(a)(2). (In applying section 1504(a)(2) for this purpose, the objective is to harmonize section 332 and section 1504(a)(2). Thus, it is generally intended that other parts of new section 1504(a), e.g., section 1504(a)(4), are applicable. However, section (a)(5)(E) is not applicable. It is not concerned with

section 1504(a)(2) but rather with the effect of transfers within a group of a member's stock.) The new rule also applies even if one (or both) of the corporations involved is not an includible corporation under section 1504(b). Under this rule, S in the first example above could be liquidated under section 332. However, S could avail itself of section 337 only if P complied with section 337(c)(3)(A)(i). In the second example above, J would be taxed because section 332 would not apply and because J and K, by definition, could not be filing a consolidated return.

Under the bill, the term "distributee corporation" under section 337(c)(3) is also amended. The amendment defines the term to mean any corporation which receives a distribution in a complete liquidation of the selling corporation to which section 332 applies. It also includes each other corporation "up the line" which receives a distribution in complete liquidation of another distributee corporation to which section 332 applies. Thus, assume, for example, that (1) M owns 100 percent of the stock of N, (2) N owns 100 percent of the stock of O, and (3) the 3 corporations are filing a consolidated return under new section 1504 for the calendar year 1985. If M transfers 30 percent of the stock of N to O, under regulations, the 3 corporations would continue to be eligible (or be required) to file a consolidated return (sec. 1504(a)(5)(E)). If N adopted a plan of complete liquidation, sold all its assets, and then liquidated within 12 months, under Treas. regs. sec. 1.1502-34, both M and O generally would be entitled to tax-free treatment under section 332. Under the bill, N could not avail itself of section 337 unless, among other things, both M and O complied with section 337(c)(3)(A)(i).

Also, under the bill, the definition of "qualified stock purchase" in section 338 is conformed to the definition in section 1504(a)(2). The change will apply where the 12 month acquisition period begins after September 27, 1985.

The amendment to section 337(c)(3)(B) applies with respect to plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after December 31, 1984. Thus, in the example above involving J and K, K could not avail itself of section 337 unless J timely liquidated because J would be a "distributee corporation" under the amendment.

Except as indicated below, the amendment to section 332 is generally applicable with respect to distributions pursuant to plans of liquidation adopted after March 28, 1985. Except as indicated below, the amendment is also applicable with respect to distributions pursuant to a plan of complete liquidation adopted on or before that date, but only if (1) any distribution is made in a taxable year beginning after December 31, 1984, and (2) the liquidating corporation and any corporation which receives a distribution in complete liquidation of such corporation are members of an affiliated group of corporations which is filing a consolidated return for the taxable year which includes the distribution. However, the amendment to section 332 does not apply with respect to distributions pursuant to any plan of complete liquidation if the liquidating corporation is a member of an affiliated group of corporations under section 60(b)(2) or (5) (relating to Native Corporations established under the Alaska Native Claims Settlement Act) of the Act for each taxable year in which it makes a distribution.

The application of the effective date rules is illustrated by the following examples.

Example (1).—Assume that Q Corporation's ownership of the stock of R Corporation satisfies section 332 of present law and section 1504 of prior law but not section 332 as it is amended by the bill. (Under these facts, Q and R could not be filing a consolidated return unless grandfathered under the Act's amendment of section 1504). Assume further that R adopts a plan of complete liquidation on October 1, 1984, then sells its assets, and, then, before October 1, 1985, completely liquidates. Regardless of whether Q and R are filing consolidated returns under section 60(b)(2) of the Act for the calendar year 1985, and regardless of whether the liquidation is completed before January 1, 1985, the amendment to section 332 would not apply. As a result, R's liquidation could qualify under section 332. (However, R could avail itself of section 337 only if Q timely liquidated.)

Example (2).—Assume that S Corporation's ownership of the stock of T Corporation would satisfy new section 332 but not section 332 of present law or section 1504 of prior law. Assume further that on October 1, 1984, T adopts a plan of complete liquidation and then, making no sales or exchanges of assets in the interim, completes its liquidation on October 5, 1984. The amendment to section 332 would not apply. As a result, section 332 could not apply.

Example (3).—The facts are the same as in Example (2) except that (a) T adopts its plan on January 10, 1985, and completes its liquidation on January 15, 1985, and (b) S and T file a consolidated return for the calendar year 1985 under new section 1504. The amendment to section 332 would be applicable. As a result, section 332 could be applicable.

Example (4).—The facts are the same as in Example (2) except that T sells assets between October 1, 1984, and October 5, 1984. New section 332 would not be applicable. As a result, section 332 could not apply, and T could avail itself of section 337.

Example (5).—The facts are the same as in Example (3) except that T sells assets between January 10, 1985, and January 15, 1985. The amendment to section 332 would apply. As a result, section 332 could apply. If it did, T could not avail itself of section 337 unless, among other things, S timely liquidated. (If S and T were not filing a consolidated return under new section 1504 for the calendar year 1985, the amendment to section 332 would not apply. As a result, T's liquidation would not be a section 332 liquidation, and T could avail itself of section 337.)

Example (6).—Assume that Corporation U's ownership of the stock of Corporation V satisfies section 332 of present law but not section 332 as it would be amended and that U and V are filing a consolidated return for the calendar year 1985, under section 60(b)(2) of the Act. On December 10, 1985, V adopts a plan of complete liquidation, then sells all its assets, and then liquidates on December 15, 1985. The amendment to section 332 would not apply. As a result, section 332 could apply. If it did, V could avail itself of section 337 only if, among other things, U timely liquidated.

i. Earnings and profits (sec. 1504(f) of the bill and sec. 312 of the Code)

Present Law

The Act substantially revised the definition of a corporation's "earnings and profits".

One change was to increase a distributing corporation's earnings and profits by the amount of any gain which would be recognized if section 311(d)(2) did not apply to an ordinary, non-liquidating distribution by the corporation of appreciated property. However, the Act added no separate provision for reducing earnings and profits for all or any portion of that amount.

The Act also amended the rules regarding the effect on earnings and profits of a corporation's redemption of its own stock (sec. 312(n)(8) of current law). However, the Act did not contain a specific effective date for that amendment.

In addition, the Act provided that the rules relating to LIFO inventory, installment sales and completed contract method of accounting would apply to foreign corporations only in the case of taxable years beginning after December 31, 1985.

Explanation of Provision

The bill repeals section 312(n)(4) and section 312(c)(3) and amends section 312(b). Under 312(b), as amended, the distribution by a corporation of property the fair market value of which exceeds its adjusted basis increases the earnings and profits of the distributing corporation by the amount of such excess. The distribution also decreases the distributing corporation's earnings and profits by the lesser of (1) the fair market value of the distributed property, and (2) its earnings and profits (as increased under the rule described in the preceding sentence). The decrease is to be treated as occurring immediately after the distribution. Thus, assume that a corporation has no accumulated earnings and profits and no other current earnings and profits. Assume further that in 1985 it distributes property with a zero basis and a $1,000 value to an individual shareholder in a transaction described in section 311(d)(2). The distribution increases the distributing corporation's earnings and profits to $1,000, so the shareholder generally would have dividend income of $1,000. The distributing corporation's earnings and profits are then reduced to zero. (This change is not intended to affect the determination of earnings and profits with respect to a liquidating distribution for purposes of section 333.)

The bill provides that section 312(n)(8) of current law applies to redemption distributions in taxable years beginning after September 30, 1984.

The effective date of the special rule for foreign corporations is changed to taxable years beginning after June 30, 1986.

j. Treatment of transferor corporation (sec. 1504(g) of the bill and sec. 361 of the Code)

Present Law

In general, gain or loss is not recognized by a transferor corporation on the transfer of property pursuant to a plan of reorganization. However, gain is recognized where money or other property received is not distributed by the transferor pursuant to the plan of reorganization. The Act generally required that all property be distributed in a "C" reorganization. Nevertheless, if the transferor corporation uses money or other property to satisfy its liabilities, the transferor corporation may be treated as realizing gain on the transfer to the acquiring corporation.[2]

In addition, under present law it is not entirely clear whether or not the nonrecognition provisions applicable to corporate liquidations apply to a corporate reorgnization.[3]

Explanation of Provision

The bill amends section 361 to provide that the transferor corporation does not recognize gain or loss on the transfer to the acquiring corporation pursuant to the plan of reorganization, without regard to whether properties received are distributed pursuant to the plan of reorganization.

In addition, the bill clarifies that sections 336 and 337 (relating to liquidations) are not applicable to transfers of property pursuant to the plan of reorganization. However, no gain or loss will be recognized on any disposition of stock or securities which were received pursuant to the plan of reorganization and which are in another corporation which is a party to the reorganization.

k. Collapsible corporations (sec. 1504(i) of the bill and sec. 341 of the Code)

Present Law

Under present law, subject to certain exceptions, gain from the sale or exchange of a "collapsible" corporation which has been held for more than 6 months is treated as ordinary income.

Explanation of Provision

The bill applies the collapsible corporation provisions whether or not the stock has been held 6 months. The provision will apply to sales and exchanges after September 27, 1985.

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[2] See *Minnesota Tea Company* v. *Helvering*, 302 U.S. 609 (1938), Rev. Rul. 70-271, 1970-1 C.B. 166.

[3] See *FEC Liquidating Corporation* v. *United States*, 548 F.2d 924 (Ct. Cl. 1977) (the application of which would deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor); and, *General Housewares Corporation* v. *United States*, 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 applied where the acquired corporation sold part of the stock received as consideration for its assets in a reorganization and used the sale proceeds to pay debts).

l. Golden parachutes (sec. 1504(j) of the bill and sec. 280G of the Code)

Present Law

Under present law, no deduction is allowed for "excess parachute payments" and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

Parachute payment

A "parachute payment" is any payment (1) in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement); (2) to (or for the benefit of) a "disqualified individual"; (3) if such payment is contingent on a change in the ownership or effective control of a corporation, or on a change in the ownership of a substantial portion of its assets—but only if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds 3 times the disqualified individual's "base amount."

The disqualified individual's "base amount" is the average annual income in the nature of compensation with respect to the acquired corporation includible in the disqualified individual's gross income over the 5 taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of such corporation. Personal service corporations and similar entities generally are treated as individuals for this purpose.

To be a parachute payment, a payment must be contingent on a change in ownership or control. In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not in fact have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not have, in fact, been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred.

A payment may also be contingent on a change of ownership or control if the change determines the time such payment is in fact to be made. The committee understands, however, that present law does not require that a payment that is merely accelerated by a change of ownership or control is to be treated as contingent on the change if the acceleration does not increase the present value of the payment. For example, the exercise of a currently vested and exercisable stock appreciation right (SAR) is not treated as a parachute payment merely because a change of control determines the time at which the SAR is exercised.

Similarly, if an employee receives payment of his or her vested account balance in an individual account plan, whether or not qualified under the Code (sec. 401(a)), and actual interest or other earnings on plan assets are credited to each account before payout, early payment would not increase the present value of this amount

and this payment would not be a parachute payment. On the other hand, if a vested employee receives a pension benefit on change in control and the amount of the benefit is not actuarially reduced to reflect earlier payment, the employer is subsidizing the value of the early payment and the pension would be a parachute payment to the extent of the excess of the present value of the early payment with the subsidy over the present value of the benefit at the earliest date that the employee otherwise could retire under the plan.

"Excess parachute payments" are any parachute payments in excess of the base amount that are not reasonable compensation for personal services actually rendered (or to be rendered) by the disqualified individual. Under present law, the taxpayer has the burden of establishing, by clear and convincing evidence, that a parachute payment is reasonable compensation for personal services actually rendered.

Reasonable compensation

To the extent the taxpayer establishes that the payment involved is reasonable compensation for personal services, the amount involved is first applied against the base amount.

Payments of compensation previously earned are generally to be treated as reasonable compensation under present law, assuming they qualify as reasonable compensation under section 162. For example, if pension benefits are earned at a rate of 2 percent a year times years of service times final average compensation, benefits earned for service before a change in control are amounts previously earned. Therefore, these benefits are treated as reasonable compensation under this provision (after discounting for the probability that, absent the change, they would otherwise have been forfeited) if they so qualify under section 162 even if the benefits vest on a change in control. Of course, because these payments would not have otherwise been paid without the change in control, they would be parachute payments.

Violation of securities laws or regulations

Under present law, the term parachute payment also includes any payment under a contract that (1) provides for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) violates any applicable securities laws or regulations. However, the rules relating to reasonable compensation are not applicable in determining how much of any such parachute payment is excessive.

Application

In determining whether payments contingent on a change in ownership or control equal or exceed 3 times the base amount, the value of amounts to be paid in the future is to be determined on a present value basis in accordance with the principles of section 1274(b)(2). Under that section, a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually, is to be used. Except as regulations may provide to the contrary, present values are to be determined as of the date the contract under which the payments are to be made becomes operative.

The provisions are applied to that part of each parachute payment which is in excess of the portion of the base amount allocated to such payment. Under present law, the portion of the base amount allocated to any payment is that portion of the base amount determined by multiplying the base amount by a fraction the numerator of which is the present value of such payment, and the denominator of which is the aggregate present value of all such payments.

Effective dates

The provisions of the Act are effective for payments made under contracts entered into or renewed after June 14, 1984. The provisions are also effective for all payments made under a contract entered into before June 15, 1984, if, after June 14, 1984, the contract is amended or supplemented in significant relevant respect. A contract generally is to be treated as amended or supplemented if it is amended or supplemented to add or modify, to the executive's benefit, a change in ownership or control trigger, to increase amounts payable (or, if payment is to be made under a formula, to modify, to the executive's advantage, the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger.

Explanation of Provisions

Exemption for small business corporations

Under the bill, the term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided shareholder approval was obtained.

A corporation qualifies as a small business corporation if the corporation does not (1) have more than 35 shareholders, (2) have a shareholder who is not an individual (other than an estate or a qualifying trust), (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock.

The Secretary of the Treasury may, by regulations, provide that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise. The committee also concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisions by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of the entity's assets. The committee contemplates that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than of the entity itself. On the other hand, if the entity's interest in the corporation constitutes less than substantial portion of its assets, approval of the compensation arrangement by the au-

thorized officer of the entity is sufficient because, under present law, the golden parachute provisions do not apply to the sale of less than a substantial portion of the assets of a corporation (in this case, the entity).

The shareholder approval requirements are met with respect to any payment if (1) the payment is approved by a separate vote of the shareholders who, immediately before the change in control, hold more than 75 percent of the voting power of all outstanding stock of the corporation and (2) adequate disclosure was made to all shareholders of the material facts concerning payments that otherwise would be parachute payments. The committee intends that adequate disclosure to shareholders will include full and truthful disclosure of the material facts and such additional information as may be necessary to make the disclosure not materially misleading. Further, the committee intends that an omitted fact will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important.

A disqualified individual who is to receive payments that would be parachute payments (absent shareholder approval) and who is a shareholder is removed from the shareholder base against which the shareholder approval test is applied. A shareholder who is related (under the principles of sec. 318) to the disqualified individual described in the preceding sentence is also removed from the shareholder base. If all shareholders are disqualified individuals or related to disqualified individuals, then disqualified individuals are not removed from the shareholder base.

Reasonable compensation

In the case of any payment made on account of a change in control, the amount treated as a parachute payment will not include the portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in control. Moreover, such payments are not taken into acccount in determining whether the threshold (i.e., 3 times the base amount) is met.

The committee intends that, evidence that amounts paid to a disqualified individual are not significantly greater than amounts of compensation (other than compensation contingent on a change of control or termination of employment) paid to the disqualified individual in prior years or customarily paid to similarly situated employees by the employer or by comparable employers will normally serve as clear and convincing evidence of reasonable compensation. In addition, the amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control. For purposes of this provision, reasonable compensation for services performed before the date of change is first offset against the base amount.

Exception for payments under qualified plans

Under the bill, the term parachute payment does not include any payment to or from a qualified pension, profit-sharing, or stock

bonus plan (sec. 401(a)), a qualified annuity plan (sec. 403(a)), or a simplified employee pension (sec. 408(k)). Moreover, such payments from or under a qualified plan are not taken into account in determining whether the threshold is met.

Treatment of affiliated groups

The bill provides that, except as otherwise provided in regulations, all members of an affiliated group of corporations (sec. 1504) shall be treated as a single corporation for purposes of the golden parachute provisions. Any person who is an officer or highly compensated individual with respect to any member of the affiliated group is treated as an officer or highly compensated individual of such single corporation. Notwithstanding the general definition of an affiliated group of corporations, for purposes of this provision, an affiliated group of corporations also includes the following:

(1) Tax-exempt corporations;

(2) Insurance companies;

(3) Foreign corporations (unless the disqualified individual is employed by a foreign corporation that is acquired by another foreign corporation, neither of which is subject to tax in the U.S.);

(4) Corporations with respect to which an election under which a possession tax credit election (sec. 936) is in effect for the taxable year;

(5) Regulated investment companies and real estate investment trusts; and

(6) A DISC or former DISC.

Definition of highly compensated individual

Under the bill, the term highly compensated individual is defined to mean an individual who is among the highest-paid one percent of the individuals performing services for the corporation.

Effective date

The provisions are effective as if enacted in DEFRA. Thus, amounts paid under an agreement otherwise subject to the golden parachute provisions may be exempt from such provisions under either the small business corporation exception or the shareholder approval exception. In addition, shareholder approval could be obtained after the date of enactment with respect to prior transactions.

With respect to the effective date for contracts that are amended or supplemented after June 14, 1984, the committee intends that present law does not require that other payments to the executive, the trigger, amount, or time of receipt of which are not affected by an amendment or supplement be treated as supplemented by reason of such amendment or supplement.

m. Corporate tax preferences (sec. 1504(k) of the bill and sec. 291 of the Code)

Present Law

The Act generally increased the corporate tax preference cutback (sec. 291) from 15 to 20 percent.

Explanation of Provision

The bill makes several clerical amendments, including a clarification that the prior law DISC provision did not apply to subchapter S corporations.

5. Partnership Provisions

a. Retroactive allocations (sec. 1505(a) of the bill and sec. 706(d) of the Code)

Present Law

The Act provides that specified cash basis items are allocated to the persons who were partners during the period to which the items were economically attributable. Items (or portions of items) which are attributable to periods before the beginning of the taxable year are assigned to the first day of the taxable year. The items are allocated to the persons who were partners during the period to which each item is attributable, in accordance with their varying interests in the partnership during that period. If the persons to whom all or part of such item is allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is properly taken into account, their portion of such item must be capitalized by the partnership and allocated to the basis of partnership assets.

Explanation of Provision

The bill clarifies that the rule described in present law applies to all cases in which the rule is necessary to allocate cash basis items to the period to which the items are attributable, even though no change in partnership interests occurs during the current taxable year.

b. Disguised sale transactions (sec. 1505(b) of the bill and sec. 707(a)(2)(B) of the Code)

Present Law

The Act provides that, under Treasury regulations, if (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers described above are properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a transaction between the partnership and a non-partner or as a transaction between two or more partners acting in non-partnership capacities. This "disguised sale" rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership, and thereby to defer or avoid tax on the transaction.

Explanation of Provision

The bill specifies that "disguised sale" treatment is to apply to cases in which the transfers to and from the partnership (as described above), when viewed together, are properly characterized as an exchange of property, as well as to cases in which such transfers are properly characterized as a sale.

c. Transfers of partnership interests by corporation (sec. 1505(c)(1) of the bill and sec. 386 of the Code)

Present Law

The Act provided that for purposes of determining the amount (and character) of gain recognized by a corporation on any distribution or liquidating sale or exchange of a partnership interest, the distribution (or sale or exchange) is treated as a distribution (or sale or exchange) of the corporation's proportionate share of the recognition property of the partnership.

Explanation of Provision

The bill amends section 386 to specifically limit the amount of gain recognized by a corporation upon a distribution of a partnership interest in a nonliquidating distribution to which section 311 applies. The maximum amount of gain recognized by a corporation upon distribution to which section 311 applies of any partnership interest is the gain that would have been recognized upon the sale of the distributed interest at its fair market value. Thus, for example, a corporation that acquired its interest by making a cash contribution to an existing partnership would recognize no gain if it immediately distributed the interest to its shareholders, regardless of the basis of the partnership property attributable to its interest.

The amendment to section 386 does not affect the recognition of recapture income by a distributing corporation. Under section 751(a), a partner is required to treat the sale of a partnership interest as a sale or exchange of property other than a capital asset to the extent of the unrealized receivables (including recapture property) and inventory of the partnership attributable to the transferred interest. Thus, a corporation making a distribution of a partnership interest will recognize depreciation recapture with respect to the partnership recapture property attributable to the distributed interest.[4]

The Secretary is given authority to promulgate regulations to prevent the use of this provision to avoid the nonrecognition of loss rule of section 311(a). In particular, the Committee is concerned that prior to a distribution of partnership interests a corporation might contribute to a partnership property the adjusted basis of which exceeds its fair market value, thereby reducing the gain inherent in the distributed partnership interests. Such "netting" of gain and loss property is not permitted by section 311 if loss property is distributed by a corporation. The Secretary should limit the application of this provision where a distribution is preceded by the

[4] See H.R. Rept. 98-432, Part 2, (98th Cong., 2nd Sess.) p. 1226, for explanation of similar provision as reported by the Committee on Ways and Means as part of the Tax Reform Act of 1984.

contribution of loss property to the partnership if the principal purpose of the contribution is to avoid the nonrecognition of loss rule.

d. Distributions treated as exchanges for purpose of partnership provisions (sec. 1505(c)(2) of the bill and sec. 761(e) of the Code)

Present Law

The Act provides that any distribution not otherwise treated as an exchange is to be treated as an exchange for purposes of specified partnership provisions of the Code. The provisions to which this rule applies are section 708 of the Code (relating to continuation of a partnership); section 743 (relating to the optional adjustment to the basis of partnership property); and any other partnership provision (subchapter K of the Code) specified in Treasury regulations.

Explanation of Provision

The bill limits the application of the sale or exchange treatment rule to partnership interests which are distributed. The bill also allows the Secretary to provide exceptions to these rules.

e. Like-kind exchanges (sec. 1505(d) of the bill and sec. 1031(a) of the Code)

Present Law

Under the Code (section 1031), generally no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment.

The Act provides that, for purposes of the like-kind exchange provision, property which was not identified as the property to be received by the taxpayer on the date the taxpayer relinquishes property, or before the day which is 45 days after that date, does not qualify as like-kind property.

Explanation of Provision

The bill specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.

6. Trust Provision

Multiple trusts (sec. 1506(a) of the bill and sec. 643 of the Code)

Present Law

The Act provides that under Treasury regulation, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same pri-

mary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts in the avoidance of Federal income tax.

This provision is effective for taxable years beginning after March 1, 1984.

Explanation of Provision

The bill provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

7. Accounting Provisions

a. Premature accruals (sec. 1507(a) of the bill and sec. 461(h) of the Code)

Present Law

Under present law, an accrual basis taxpayer may not take a deduction for an item prior to the occurrence of economic performance. A liability of a taxpayer which requires a payment to another person and arises out of a tort is not considered to be economically performed prior to the time payment to such other person is made.

Explanation of Provision

The bill provides that accrual basis taxpayers which have made a payment to an insurance company to indemnify themselves from tort claims arising from personal injury or death caused by the inhalation or ingestion of dust from asbestos-containing products will be treated as having satisfied the economic performance test if the payment is paid to an unrelated third party insurer prior to November 23, 1985, and such payment is not refundable. The provision is not to apply to any company which mined asbestos.

The committee does not intend for any conclusion to be drawn from this provision as to what treatment should be accorded similar payments for similar policies in the future.

b. Tax shelters (sec. 1507(a)(1) and (2) of the bill and sec. 461(i)(2) of the Code)

Present Law

Generally, a cash basis tax shelter is not allowed a deduction with respect to an amount any earlier than the time at which economic performance occurs. An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year. For purposes of this exception, in the case of oil and gas activities, economic performance is deemed to occur with respect to intangible drilling expenses when the well is "spudded." It is unclear whether the exception applies if economic performance occurs before the close of the taxable year, because this is not "within" 90 days after the close of the taxable year. For example, it is unclear whether the exception applies if a well is spudded in the last month of the taxable year.

In the case of the trade or business of farming, the farming syndicate rules of section 464 apply to any tax shelter described in section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). For purposes of applying section 464 to these tax shelters, it is unclear whether the exceptions under section 464(c)(2) relating to holdings attributable to active management apply.

Explanation of Provision

The bill clarifies that the 90-day exception applies if economic performance occurs before the close of the 90th day after the close of the taxable year. Thus, for example, if a well is spudded in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year is satisfied.

The bill also clarifies that any tax shelter described in section 6661(b) will generally be treated as a farming syndicate for purposes of section 464. However, any person meeting the requirements of section 464(c)(2) will not be subject to the provisions of section 464 with respect to that person's interest in a tax shelter.

c. Mine reclamation and similar costs (sec. 1507(a)(3) of the bill and sec. 468 of the Code)

Present Law

The Act provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal, State, or local law. Deductions accrued under this method must be accounted for in a book reserve and are subject to recapture to the extent that reclamation costs are less than accumulated reserves.

Explanation of Provision

The bill clarifies that a reserve balance must be increased by the amount of deductions accrued in each year that are allocable to the reserve. The bill also clarifies that this provision is effective for taxable years ending after July 18, 1984.

d. Nuclear power plant decommissioning expenses (sec. 1507(a)(4) of the bill and sec. 468A of the Code)

Present Law

The Act permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund (a "fund"), subject to certain limitations.

Explanation of Provision

The bill clarifies that a taxpayer shall be deemed to have made a payment to a fund at the end of a taxable year provided that payment is made within 2½ months after the close of that taxable year. Under a transitional rule, the Secretary of the Treasury is provided regulation authority to relax, and appropriately adjust,

this 2½ month rule for payments allocable to a taxable year beginning before January 1, 1986, and to provide that no interest will be allowed with respect to periods before payment is made. The bill clarifies that the tax treatment of fund income provided in sec. 468A is in lieu of any other Federal income tax, that a fund's tax liability is not deductible from its gross income, and that for purposes of subtitle F ("Procedure and Administration") a fund shall be treated as a corporation and taxes imposed on the fund shall be treated similarly to corporate income taxes. The bill clarifies that a fund may invest only in those assets in which the Code permits a Black Lung Trust Fund to invest. The bill also clarifies that this provision is effective for taxable years ending after July 18, 1984.

e. Treatment of deferred payments for services (sec. 1507(b) of the bill and sec. 467(g) of the Code)

Present Law

Under section 467(g) of the Code, the Secretary of the Treasury is to prescribe regulations under which deferred payments for services will be subject to rules similar those those applicable to deferred rents.

Explanation of Provision

The bill clarifies that the regulations to be issued under section 467 relating to deferred payments for services will not apply to amounts to which section 404 or 404A applies, or to amounts subject to any other provision specified in regulations.

8. Tax Straddle Provisions

a. Treatment of Subchapter S corporations (sec. 1508(a) of the bill)

Present Law

The Act extended the mark-to-market and sixty percent long-term, forty percent short-term capital gain and loss treatment applicable to commodities dealers to dealers in exchange-traded options, provided elections to adopt this treatment for positions carried forward from earlier taxable years into the taxable year including the date of enactment and to pay any increase in tax liability resulting from this election over 5 years, and permitted qualified incorporated commodities dealers and options dealers to elect S corporation status without regard to the requirement of present law that the election be made by the 15th day of the third month of the taxable year for which it is effective.

Explanation of Provision

The bill makes clarifying amendments to ensure that S corporation taxable year limitations do not affect the elections relating to adoption of mark-to-market treatment for positions carried forward from earlier years, and to properly coordinate those elections with

the S corporation election with respect to taxable years commencing before January 1, 1984 in the manner provided by regulations.[5]

b. Treatment of amounts received for loaning securities (sec. 1508(b) of the bill and sec. 263(g) of the Code)

Present Law

The present law requirement that interest and other carrying costs incurred to carry personal property constituting part of a straddle must be capitalized, as amended by the Act, limits the requirement to the excess of these costs over interest, discount income and dividend income with respect to the property that is subject to tax during the taxable year. A lender of securities to be used in a short sale may receive compensation from the borrower to replace interest, dividends, and other compensating amounts with respect to the loaned property and may also incur interest and other carrying costs with respect to the property that are subject to the capitalization requirement.

Explanation of Provision

The bill provides for the inclusion of compensating payments to a lender of securities used in a short sale in those taxable amounts that reduce interest and other costs required to be capitalized under section 263(g) of the Code.

c. Clarification of the exception for straddles consisting of stock (sec. 1508(c) of the bill and sec. 1092(d) of the Code)

Present Law

The Act extended the straddle rules to straddles involving exchange-traded stock options. Exceptions were provided for a straddle consisting of stocks, or stock and a qualified cover call.

Explanation of Provision

The bill clarifies that the exception for stock does not operate to except straddles involving exchange traded stock options (other than qualified covered calls that offset stock).

d. Treatment of losses from pre-1981 straddles (sec. 1508(d) of the bill and sec. 108 of the Act)

Present Law

Unlike taxpayers who conducted isolated straddle transactions prior to the effective date of ERTA solely for tax purposes, taxpayers in the trade or business of trading commodities conducted numerous straddle transactions in the normal course of their business. Section 108 was intended to clarify the treatment of losses claimed with respect to straddle positions entered into and disposed of prior to 1982 by taxpayers in the trade or business of trading commodities. It provided a profit-motive presumption in section 108(b) for such taxpayers because of the inherent difficulty in dis-

[5] See Treas. Reg. sec. 18.1362-1, 49 Fed. Reg. 38920 (October 1, 1984).

tinguishing tax-motivated straddle transactions from profit-motivated straddle transactions when the taxpayer was in the trade or business of trading in commodities.

Explanation of Provision

The bill makes clear that subsection (b) treatment is limited to those taxpayers in the business of trading commodities. The determination of whether a taxpayer is in the business of trading commodities is based upon all the relevant facts and circumstances. Under the statute as clarified by the technical correction, generally a taxpayer engaged in the business of investment banking who regularly trades in commodities as a part of that business would be considered in the trade or business of trading commodities. If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently.

In the case of trades on a domestic exchange described in Code section 1402(i)(2)(B), the identification of positions disposed of shall be as provided in exchange procedures, and records of the exchange or clearinghouse shall be controlling in the absence of proof that rules were violated. A taxpayer who does not satisfy the indicia of trade or business status, such as the taxpayer in *Miller* v. *Commissioner* (84 T.C. No. 55 (1985)), would not be considered in the trade or business of trading commodities. Further, the presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member. The subsection (b) treatment is only for purposes of subsection (a), and no inference should be drawn that a loss is incurred in a trade or business for any other purpose, such as for purposes of section 162, 163(d) or 172.

Section 108 also restated the general rule that losses from the disposition of a position in a straddle are only allowable if such position was part of a transaction entered into for profit. A majority of the United States Tax Court in *Miller* interpreted section 108 as providing a new, less stringent profit standard for losses incurred with respect to pre-1981 commodity straddles. It was not the intent of Congress in enacting section 108 to change the profit-motive standard of section 165(c)(2) or to enact a new profit motive standard for commodity straddle activities. This technical correction is necessary to end any additional uncertainty created by the *Miller* case.

9. Depreciation Provisions

a. Straight-line election for low-income housing (sec. 1509(a)(1) of the bill and sec. 168 of the Code)

Present Law

Section 111 of the Act extended the recovery period of real property (other than low-income housing) from 15 years to 18 years. Taxpayers may elect to recover the cost of 18-year real property using a straight-line method over the regular 18-year recovery period.

Explanation of Provision

The bill clarifies that taxpayers may elect to recover the cost of low-income housing using a straight-line method over 15 years (but not 18 years).

b. Mid-month convention for real property (sec. 1509(a)(2) of the bill and secs. 57, 168, and 312 of the Code)

Present Law

The Act provided a mid-month convention for the depreciation of 18-year real property (which does not include low-income housing). Under that convention, property placed in service (or disposed of) by a taxpayer at any time during a month is treated as having been placed in service (or disposed of) by the taxpayer in the middle of that month.

Explanation of Provision

The bill clarifies that the mid-month convention is to be applied whenever a depreciation computation with respect to 18-year real property is required under section 168, section 57(a)(12) (relating to accelerated cost recovery deductions as items of tax preference), or section 312(k) (relating to the effect of depreciation on earnings and profits). Thus, for example, if a taxpayer elects under section 168(b)(3) to depreciate 18-year real property on a straight-line basis over 18, 35, or 45 years, the mid-month convention applies in computing the deductions. Similarly, the mid-month conventions applies in determining what cost recovery deductions "would have been allowable" under section 57(a)(12). Numerous conforming changes are also made.

c. Bond-financed 18-year real property (sec. 1509(a)(4) of the bill and sec. 168(f)(12) of the Code)

Present Law

Prior to the Act, section 168(f)(12) placed restrictions on cost recovery allowances with respect to 15-year real property financed by the proceeds of an industrial development bond. Those rules did not apply if the property was placed in service in connection with a project for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A). The Act generally pro-

vided that the cost of real property qualifying as recovery property could not be recovered over a period of less than 18 years.

Explanation of Provision

The bill clarifies that, in general, the cost of 18-year real property (which does not include low-income housing) financed by the proceeds of an industrial development bond cannot be recovered more rapidly than on a straight-line basis over 18 years, using a mid-month convention. This rule does not apply if the property is either (i) low-income housing (sec. 168(c)(2)(F)), or (ii) property which is placed in service in connection with a project for residential rental property financed with the proceeds of obligations described in section 103(b)(4)(A) but which is not low-income housing under section 168(e)(2)(F). Costs of the former can be recovered on an accelerated basis under ACRS over 15 years, using a first-of-the month convention, and costs of the latter can be recovered on an accelerated basis under ACRS over 18 years, using a mid-month convention.

The bill also clarifies that the provision of the Act relating to property financed with tax-exempt bonds does not apply to certain property excepted from the bond rules added in 1982.

d. Treatment of certain transferees of recovery property (sec. 1509(b) of the bill and sec. 168(f)(10) of the Code)

Present Law

A transferee of recovery property generally may elect a recovery period or method for the property different from the period or method elected by the transferor. However, restrictions are imposed by section 168(f)(10) to prevent the use of certain kinds of asset transfers as a means to change the recovery period or method for the property involved. For transfers subject to those restrictions, the transferee must "step into the shoes" of the transferor with respect to so much of the transferee's basis in the property as is not in excess of the property's adjusted basis in the hands of the transferor. Under this rule, the transferee's cost recovery deductions with respect to that basis are the same as those that would have been allowed the transferor had no transfer occurred. The transferee can elect to depreciate any excess basis pursuant to any recovery period or method available under the general rules.

Asset transfers subject to the rule of the preceding paragraph include sale-leasebacks (sec. 168(f)(10)(B)(iii)), transfers between related persons (sec. 168(f)(10(B)(ii)), and tax-free asset (carryover basis) transfers described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (sec. 168(f)(10)(B)(i)).

Explanation of Provision

In cases described in sections 168(f)(10)(B)(ii) and (iii) of present law, the "step into the shoes" rule is often too generous to the transferee. The rule has the general effect of permitting such a transferee higher cost recovery deductions than would have been allowed to a transferee in a case not covered by either section. Furthermore, the Act, in amending the rules regarding the depreciation of real property (other than low-income housing) qualifying as

recovery property, did not clearly provide how section 168(f)(10) would apply.

The bill amends section 168(f)(10) with respect to recovery property placed in service by the transferor. In a case described in section 168(f)(10)(B)(ii) or (iii) (but not (i)) of present law, the transferee does not "step into the shoes" of the transferor. Instead, the transferee starts depreciating the property as would any other new owner of it. However, to the extent of the adjusted basis of the property in the hands of the transferor, the transferee is treated as having made any election made by the transferor with respect to the property under section 168(b)(3) or section 168(f)(2)(C). Thus, for example, if the transferor had elected to depreciate 5-year property on a straight-line basis over 5 years, a transferee under section 168(f)(10)(B)(ii) or (iii) would be treated as having made the same election to the extent basis did not increase. Furthermore, the transferee would begin depreciating that basis in the year of the transfer over a new 5-year period. For purposes of this rule, if the transferor was depreciating 15-year real property on a straight-line basis, the transferee would be treated as having elected 18-year straight line depreciation. If the transferee's basis exceeded the transferor's adjusted basis, the transferee can depreciate the excess under the general rules. The bill is not intended to affect the treatment of transactions between members of an affiliated group of corporations filing a consolidated return.

With one exception, the bill does not amend section 168(f)(10)(B)(i). Thus, for example, in a section 351 transaction, the transferee steps into the transferor's shoes to the extent basis does not increase. However, the bill amends section 168(f)(10)(B)(i) to provide that it does not apply in the case of the termination of a partnership under section 708(b)(1)(B) (relating to the sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period).

The amendments generally apply to property placed in service by the transferee after September 27, 1985.

e. Films, videotapes, and sound recordings (sec. 1509(c) of the bill and sec. 167 of the Code)

Present Law

Under the Act, films and videotapes cannot qualify as recovery property (sec. 168(e)(5)). Similarly, sound recordings do not qualify as recovery property unless an election is made under section 48(r)(1) (relating to treating a sound recording as 3-year property). Thus, their costs cannot be recovered under ACRS. If a film or videotape, or a sound recording, not qualifying as recovery property qualifies as tangible property, however, its costs may be recoverable under depreciation methods prescribed by section 167(b) (e.g., a declining balance method).

Explanation of Provision

Under the bill, films, videotapes, and sound recordings are not eligible for the accelerated depreciation methods available under sec-

tion 167(b)(2), (3), or (4). However, the income forecast method or similar methods of depreciation are available.

The provision applies to films, videotapes, and sound recordings placed in service by the taxpayer after March 28, 1985. However, no inference is intended as to whether or not films, videotapes, or sound recordings, placed in service by a taxpayer on or before that date qualify for these accelerated depreciation methods.

f. Investment tax credit (sec. 1509(d) of the bill and sec. 48 of the Code)

Present Law

The Act amended the 3-month rule of section 48(b) (relating to whether property qualifies as new section 38 property). Under the Act, rules relating to the qualification of certain property reconstructed by the taxpayer as new section 38 property were inadvertently deleted.

Explanation of Provision

The bill reinstates the provision that section 38 property the reconstruction of which is completed by the taxpayer qualifies as new section 38 property. The bill also provides that the 3-month rule is not applicable to section 38 property the reconstruction of which is completed by the taxpayer. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 3 months of the date actually placed in service is to be treated as placed in service on the date actually placed in service.

The bill also clarifies the applicability of the 3-month rule in the case of certain sale-leasebacks. Thus, assume that taxpayer A places eligible property in service by leasing it to taxpayer B. Assume further that, within 3 months of the date A placed the property in service, A sells the property to taxpayer C and taxpayer C leases the property back to A, subject to the lease to B. Assuming C's lease to A qualifies as a lease under applicable Code principles, the property will constitute new section 38 property in C's hands. The amendment clarifies that this result would occur under the prior statutory language.

Under the bill, the 3-month rule does not apply if the lessee and lessor so elect.

10. Foreign Provisions

a. Maintaining the source of U.S. source income (sec. 1510(a) of the bill and sec. 904(g) of the Code)

Present Law

Prior to the Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: Interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The Act added to the foreign tax credit rules new rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. These rules do not apply if less than 10 percent of the foreign corporation's earnings and profits is from U.S. sources.

Interest and dividends paid by a domestic corporation that earns less than 20 percent of its gross income from U.S. sources over a three-year period (an "80/20 company") are foreign source (Code secs. 861(a)(1)(B) and 861(a)(2)(A)). Therefore, a U.S. taxpayer can convert U.S. source income to foreign source income by routing it through an 80/20 company, as long as the company's U.S. source gross income remains below the 20-percent threshold.

The Act provides a transitional rule for certain interest received by "applicable CFCs." The Act defines an "applicable CFC" as any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of issuing CFC obligations or holding short-term obligations and lending the proceeds to affiliates. The Act provided that, if certain requirements are met, interest paid to an applicable CFC on a U.S. affiliate obligation issued before June 22, 1984 (the date of conference action) will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated. This rule exempts from the resourcing provisions interest paid by a U.S. affiliate on certain obligations issued before the effective date of the amendment by a U.S.-owned finance subsidiary located in the Netherlands Antilles.

A U.S. affiliate obligation is any obligation of a U.S. person related (within the meaning of Code section 482) to an applicable CFC holding the obligation. Interest paid on an obligation of a foreign person is not subject to the source maintenance rules.

Under the U.S. Constitution, the more recently adopted of a conflicting treaty and statute generally takes precedence. Thus, a treaty ratified in the future that contains its own source rules arguably might override the source maintenance rules. A preexisting treaty containing such rules would not do so under the constitutional rule. While under a Code provision in effect since 1936, some statutory taxing rules in effect yield to preexisting treaties, this Code rule applies only in the case of a treaty exclusion from gross income; treaty source rules are not exclusions from gross income. Consistent with these general rules, Congress intended that the new rules maintaining the source of U.S. source income take precedence over any conflicting U.S. treaty provisions in force when it enacted the Act. Congress also intended that the source maintenance rules take precedence over any conflicting U.S. treaties entered into in the future, absent an express intention in the treaty to override the rules. Some argue that certain U.S. treaties awaiting ratification may conflict with the source maintenance rules.

Explanation of Provision

Under the bill, an 80/20 company will be treated as a U.S.-owned foreign corporation and thus will be subject to the rules maintaining the source of U.S. source income. The bill thereby prevents U.S.

taxpayers from using 80/20 companies to convert U.S. source income to foreign income.

This provision generally will take effect on March 28, 1985. In the case of any taxable year of an 80/20 company ending after March 28, 1985, only income received or accrued by the 80/20 company during that portion of the taxable year after that date generally is to be taken into account for purposes of the new source maintenance rules. However, *all* income received or accrued by the 80/20 company during that taxable year is to be taken into account in determining whether the 10 percent U.S. source earnings and profits threshold for the source maintenance rules is exceeded.

The bill clarifies the applicable CFC definition. Under the bill, an applicable CFC is any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of (1) any combination of issuing CFC obligations and short-term borrowing from nonaffiliated persons and (2) lending the proceeds to affiliates.

The bill provides that certain U.S. source interest paid to an applicable CFC by an affiliated foreign corporation on an obligation of that corporation issued before June 22, 1984, will be subject to the resourcing provisions to the same extent that interest so paid by an affiliated U.S. corporation would be so subject. This treatment applies if at least 50 percent of the foreign corporation's gross income for the three-year period ending on or before March 31, 1984, and with the close of its taxable year preceding the payment of the interest in question, was effectively connected with a U.S. trade or business.

The bill makes clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation, even those entered into after the Act's date of enactment, unless the treaty clearly expresses an intent to override the rules by specific reference to them. Although the committee finds it appropriate to clarify the relation between the source maintenance rules of the Act and the treaty obligations of the United States, no inference contrary to the general rule that gives precedence to the provisions of the Act over preexisting treaty provisions should be drawn with respect to any other provision of the Act (except as specifically provided in the Act or its legislative history). In enacting the 1984 Act, Congress specifically provided that treaties were to prevail over certain statutory rules that apply to stapled stock and to the definition of residence of individuals; with these two exceptions, the committee is not aware of conflicts between the 1984 Act and treaties where the Act would not clearly take precedence. For example, it is the committee's understanding that changes made by the Act in the accumulated earnings tax provisions override a conflicting provision in the U.S. income tax treaty with Jamaica.

b. Maintaining the character of interest income (sec. 1510(b) of the bill and sec. 904(d)(3) of the Code)

Present Law

In general

The Act provided that when a U.S. taxpayer includes in income foreign personal holding company or subpart F income with respect to (or an interest or dividend payment from) a designated payor corporation that has earned substantial "separate limitation interest" (generally passive interest income), that inclusion or payment will generally constitute interest that is subject to the separate foreign tax credit limitation for interest income.

The purpose of this look-through rule is to prevent U.S. taxpayers from using foreign corporations to inflate the overall foreign tax credit limitation. Prior to the Act, U.S. taxpayers could arguably circumvent the separate foreign tax credit limitation for interest income by having low-taxed interest income paid to a foreign corporation rather than directly to them. Subpart F and foreign personal holding company inclusions with respect to the foreign corporation, and dividends and interest received from the foreign corporation, were treated as noninterest income of the U.S. taxpayers that was subject to the overall foreign tax credit limitation. As a result of an easily manipulable financial transaction, the conversion of interest income to noninterest income was possible.

Definition of designated payor corporation

The Act generally defines a designated payor corporation as any regulated investment company, 50-percent (or more) U.S.-owned foreign corporation, or foreign corporation with a ten-percent U.S. shareholder. A domestic corporation that pays foreign source dividends can be a designated payor corporation only if it is a regulated investment company.

A domestic company's dividends (and interest payments) are foreign source if it is an "80/20" company, that is, if it earns less than 20 percent of its gross income from U.S. sources for a three-year period (Code secs. 861(a)(1)(B) and 861(a)(2)(A)).

Code section 269 denies tax benefits to taxpayers who acquire control of corporations to avoid or evade tax. The extent to which section 269 applies to defeat schemes to avoid the Act's look-through rules by using U.S. or foreign corporations is not clear.

10-percent exception

The Act contains a de minimis rule that prevents characterization of inclusions and payments as interest subject to the separate foreign tax credit limitation for interest income unless 10 percent or more of the earnings and profits of the designated payor corporation is attributable to separate limitation interest. This de minimis rule applies even in the case of income inclusions that arise under the anti-avoidance rules that apply to foreign personal holding companies and controlled foreign corporations.

Related party interest

The Act provided that when a designated payor corporation receives interest from another member of the same affiliated group, the interest shall not be treated as separate limitation interest unless the interest is attributable (directly or indirectly) to separate limitation interest of the other member.

Explanation of Provisions

Definition of designated payor corporation

The bill amends the definition of designated payor corporation in two respects.

First, the bill makes clear that any corporation formed or availed of for purposes of avoiding the look-through rule will be treated as a designated payor corporation subject to the rule. For example, U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to noninterest income by earning the income through a corporation the ownership of which is structured to place the corporation technically outside the present law definition of designated payor corporation: a foreign corporation that earns sufficient earnings and profits attributable to separate limitation interest to be subject to the look-through rule, but is majority-owned by foreign persons and has no ten-percent U.S. shareholders, will be treated as a designated payor corporation (regardless of the original purpose for its formation) if U.S. shareholders utilize the corporation to remove interest income from the separate foreign tax credit limitation for interest income. Similarly, U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to noninterest income by earning the income through a foreign banking subsidiary or similar entity formed or availed of for that purpose. (Absent this anti-abuse rule, interest earned by a taxpayer in the conduct of a banking or similar business would not be subject to the separate foreign tax credit limitation for interest.) The Secretary may promulgate regulations setting forth appropriate rules for determining whether a corporation has been formed or availed of for purposes of avoiding the look-through rule.

Second, the bill expands the definition of designated payor corporation to include any 80/20 company. By subjecting 80/20 companies to the look-through rule, the bill prevents U.S. taxpayers from using 80/20 companies to circumvent the separate foreign tax credit limitation for interest income.

The first described amendment to the designated payor corporation definition generally takes effect on December 31, 1985. The second described amendment to the designated payor corporation definition generally takes effect on March 28, 1985. In the case of any taxable year of a corporation treated as a designated payor corporation by virtue of these amendments ending after the indicated date, only income received or accrued by the corporation during that portion of the taxable year after that date generally is to be taken into account for purposes of the look-through rule. However, *all* income received or accrued by the corporation during that taxable year is to be taken into account in determining whether the

ten-percent earnings and profits threshold for dividends and interest is exceeded. A corporation formed on or before December 31, 1985, but availed of after that date to avoid the look-through rule, will be subject to the rule.

10-percent exception

Consistent with the Act's rules for source maintenance, the bill removes the Act's de minimis rule that prevents maintenance of the character of interest income in the case of foreign personal holding company inclusions and Subpart F inclusions.

Related party interest

The bill makes it clear that when a designated payor corporation receives dividends or interest from another member of the same affiliated group, the amount shall be treated as separate limitation interest if (and only if) the amount is attributable (directly or indirectly) to separate limitation interest of the other member (or any other member of the group).

c. Related person factoring income (sec. 1510(c) of the bill and secs. 864 and 956 of the Code)

Present Law

Investment in U.S. property

Under present and prior law, the Code treats an investment in United States property by a controlled foreign corporation as an effective repatriation of the amount invested and thus as a dividend. The Act provided that "United States property" includes any trade or service receivable acquired from a related U.S. person if the obligor under the receivable is a U.S. person. This provision overrode exceptions (listed in Code sec. 956(b)(2)) to the investment in U.S. property rules. Among those exceptions is an exclusion from U.S. property of an amount of assets equal to post-1962 earnings and profits previously excluded from subpart F income on the ground that the United States had already subjected those amounts to tax directly as effectively connected income (sec. 956(b)(2)(H)).

Current inclusion of factoring income

The Act provided that if any person acquires a trade or service receivable from a related person, the acquirer's income from the receivable is treated as interest on a loan to the obligor under the receivable. In general, this income is currently taxable to the owners of the acquirer of the receivable under the foreign personal holding company rules or the controlled foreign corporation rules (subpart F). The income is currently taxable even when the related person that acquires the receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country.

Separate limitation treatment

Related person factoring income is treated under the Act as interest described in section 904(d)(2) and, therefore, is subject to the

separate foreign tax credit limitation for interest. Congress intended that this income be ineligible for any exception to application of the separate limitation. However, the Act does not include in its enumeration of the exceptions the affiliated group exception to the Act's rules maintaining the character of interest income (section 904(d)(3)(J)).

Explanation of Provisions

Investment in U.S. property

The bill provides that the existing exclusion from U.S. property of an amount of assets equal to the controlled foreign corporation's post-1962 earnings and profits excluded from subpart F income as taxable effectively connected income will apply in the case of the acquisition of a trade or service receivable that otherwise constitutes U.S. property.

Current inclusion of factoring income

The bill generally exempts factoring income from current inclusion when the related person that acquires the factored receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country. Factoring income is still subject to the current inclusion rule, however, if the person transferring the receivable would have derived any foreign base company income (determined without regard to the 10-percent exception) or income that is effectively connected with a U.S. trade or business had it collected the receivable.

For example, assume that a controlled foreign corporation manufactures a product in the foreign country of its incorporation and sells the product to an unrelated customer in exchange for the customer's receivable. None of the manufacturer's income from this sale is effectively connected with a U.S. trade or business, and none of it would be currently taxable to its U.S. shareholders. The manufacturer sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country. Under the bill, the income of the acquirer from that receivable is not subject to current U.S. taxation.

By contrast, assume that another controlled foreign corporation purchases goods from its U.S. parent and resells those goods to a customer (in exchange for the customer's receivable) for use outside the country of incorporation of the controlled foreign corporation. This income would be currently taxable to the U.S. shareholders of the controlled foreign corporation as foreign base company sales income under the subpart F rules (sec. 954(d)). The controlled foreign corporation sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country as the seller. Under the bill, the income of the acquirer from the receivable remains subject to current taxation at the level of its U.S. shareholders.

The bill's treatment of factoring income also extends to income from analogous loans by a controlled foreign corporation to finance transactions with related parties.

Separate limitation treatment

The bill provides that related person factoring income treated under the Act as interest is subject to the separate limitation for interest without regard to the exception to the definition of separate limitation interest for certain interest received from members of the same affiliated group.

d. Repeal of 30-percent withholding tax on portfolio interest paid to foreign persons (secs. 1510(a) and (d) of the bill and secs. 871, 881, 1441, and 1442 of the Code)

Present Law

In general

The United States generally imposes a flat 30-percent withholding tax on the gross amount of U.S. source investment income payments to foreign persons. The Act repealed the 30-percent tax with respect to portfolio interest paid on certain indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. This exemption from the 30-percent tax is effective for interest paid on qualifying obligations issued after July 18, 1984, the date of enactment of the Act.

Registered obligations—non-U.S. person statement

The Act repealed the 30-percent tax with respect to interest paid on obligations issued in registered form for which the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) receives a statement that the beneficial owner of the obligation is not a U.S. person.

Interest received by controlled foreign corporations

Interest received by a controlled foreign corporation ("CFC") from a person other than a related person may be exempt from the 30-percent tax under the Act. To prevent U.S. persons from indirectly taking advantage of the exemption, however, the Act provides that portfolio interest received by a CFC is includible in the gross income of the CFC's U.S. shareholders under subpart F without regard to any of the exceptions otherwise provided under the subpart F rules.

It appears that some interest paid by foreign corporations, which would not have been subject to the 30-percent tax *prior* to the Act, nonetheless may fall within the technical definition of portfolio interest. Where such interest is paid to a CFC, treatment of the interest as portfolio interest may subject it to current taxation under subpart F without regard to any of the subpart F exceptions.

Interest received by 10-percent shareholders—attribution rules

Congress did not extend the repeal of the 30-percent tax to interest paid to foreign persons having a direct ownership interest in the U.S. payor because the combination of U.S. deduction and noninclusion in such a case would have created an incentive for interest payments that Congress did not believe appropriate.

A direct ownership interest, for these purposes, generally means a 10-percent (or greater) ownership interest in the U.S. payor. In

determining whether direct ownership exists, the stock ownership attribution rules of the Code apply, with certain modifications (sec. 318(a)). One of the applicable attribution rules is that a corporation generally is deemed to own stock that its 50-percent -(or greater) owned subsidiary owns in proportion to the corporation's share of its subsidiary's stock (sec. 318(a)(2)(C)). In determining whether direct ownership exists for purposes of the repeal, this rule is applied without regard to the 50-percent limitation. This modification in the attribution rule prevents an affiliated group of corporations from circumventing the direct ownership exception to the 30-percent tax repeal by, for example, having a U.S. member pay interest to the 49-percent foreign owner of the U.S. member's foreign parent, rather than directly to that foreign parent.

Another of the applicable attribution rules is that a 50-percent -(or greater) owned subsidiary generally is deemed to own the stock that its parent owns (sec. 318(a)(3)(C)). The Act applies this rule in determining whether direct ownership exists for purposes of the repeal without any modification of the 50-percent limitation. This allows an affiliated group of corporations to circumvent the direct ownership exception to the 30-percent tax repeal by having a U.S. member pay interest to an affiliated foreign corporation that is as much as 49-percent-owned by a substantial foreign shareholder in the U.S. member, rather than directly to that substantial shareholder.

Explanation of Provisions

Registered obligations—non-U.S. person statement

The bill clarifies that the beneficial owner of a registered obligation, the interest on which is otherwise eligible for the repeal, may claim a refund of any tax withheld where the required non-U.S. person statement is provided *after* one or more interest payments are made rather than before. Claims for such refunds are subject to the general statute of limitations rules for refund claims (sec. 6511).

Interest received by controlled foreign corporations

The bill amends the definition of portfolio interest to exclude interest that (without regard to the operation of treaties) would not have been subject to the 30-percent tax prior to the Act. Thus, under the bill, interest received by CFCs will be denied the benefit of any otherwise applicable subpart F exceptions only if the interest would have been subject to the 30-percent tax in the absence of the repeal provision.

Interest paid to 10-percent shareholders—attribution rules

In determining whether the direct ownership exception to the 30-percent tax repeal applies, the stock ownership attribution rule of Code section 318(a)(3)(C) will apply without regard to its 50-percent ownership limitation. Where the attribution rule would not apply but for the disregard of the 50-percent limitation, a foreign interest recipient will be treated as owning the stock its foreign shareholder owns in proportion to that shareholder's ownership interest in the foreign interest recipient.

e. Original issue discount—foreign investors

(1) Deduction for original issue discount (sec. 1510(e)(1) of the bill and sec. 163 of the Code)

Present Law

The Act delayed until actual payment the deduction for interest accrued, but not paid, to related foreign lenders with respect to an original issue discount (OID) obligation.

Explanation of Provision

The bill provides that the delay in the timing of deductions for interest accrued but not paid to related foreign lenders with respect to an OID obligation does not apply to the extent that the OID income is effectively connected with the lender's conduct of a U.S. trade or business, unless the OID income is exempt from U.S. taxation or is subject to a reduced rate of tax pursuant to a treaty obligation of the United States.

(2) Taxation of original issue discount (sec. 1510(e)(2) of the bill and secs. 871 and 881 of the Code)

Present Law

Under the Act, a foreign investor that receives a taxable interest payment on an OID obligation is taxable on an amount equal to the OID accrued on the obligation since the last payment of interest thereon. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed).

Explanation of Provision

The bill provides that when a foreign investor receives a payment (whether constituting interest or principal) on an OID obligation, the amount taxable is equal to the OID accrued on the obligation that has not before been subject to tax, whether or not the OID accrued since the last payment of interest. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed), whether or not that amount exceeds the foreign investor's gain on the sale, exchange, or retirement.

f. Withholding on dispositions by foreigners of U.S. real property interests (sec. 1510(f) of the bill and secs. 897, 1445, 6039C, and 6652(g) of the Code)

Present Law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposi-

tion. FIRPTA provided for enforcement of this tax through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The 1984 Act generally repealed the information reporting requirements of FIRPTA and established a withholding system to enforce the FIRPTA tax.[6] The Act imposes a withholding duty on a transferee of a U.S. real property interest from a foreign person unless the transferee receives a sworn affidavit stating that the transferor is not foreign ("non-foreign affidavit"), or one of four other withholding exemptions (some of which are discussed in more detail below) applies. The amount withheld generally is the lesser of ten percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS). Special rules are provided (some of which are discussed further below) for withholding by partnerships, trustees, executors, distributing foreign corporations, and domestic U.S. real property holding corporations.

Corporations making section 897(i) election

The Act does not treat foreign corporations electing under Code section 897(i) to be considered domestic corporations for purposes of FIRPTA's substantive and reporting provisions as domestic corporations for withholding purposes. This was intended to simplify the non-foreign affidavit procedure. If the section 897(i) election were applicable for withholding purposes, then electing foreign corporations could provide non-foreign affidavits. Congress was concerned that there would be uncertainty on the part of U.S. buyers regarding the validity of non-foreign affidavits received from foreign corporations.

Since enactment of the Act, the Internal Revenue Service has developed a procedure that would provide U.S. buyers with reasonable assurance that a non-foreign affidavit received from a foreign corporation is valid (as a result of a valid section 897(i) election) (Temp. Reg. secs. 1.1445-2T(b)(2)(ii), 1.1445-5T(b)(3)(ii)(C), and 1.1445-7T(a)).

Withholding exemptions for transfers of stock in domestic corporations

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes a sworn affidavit to the transferee stating that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)(A)(ii)—the shorter of the period after FIRPTA's general effective date (June 18, 1980) during which the transferor held the interest and the five-year period ending on the date of disposition of the interest ("non-U.S. RPHC affidavit"). The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if the

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[6] The Act does authorize the Secretary of the Treasury to require information reporting by foreign investors not engaged in a U.S. business that hold direct investments in U.S. real property of $50,000 or more. The Secretary has not exercised that authority and has expressed a current intention not to require information reporting.

transferee has actual knowledge that the affidavit is false or the transferee receives a notice from his or her agent or an agent of the transferor that the affidavit is false.

In addition, no withholding is required on a disposition of shares of a class of corporate stock that is regularly traded on an established securities market.

Notice-giving and withholding responsibilities of agents

A transferor's agent or transferee's agent with actual knowledge that a non-foreign or non-U.S. RPHC affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor is deemed to have actual knowledge that any non-foreign affidavit furnished by the transferor is false. Congress believed that any agent deriving compensation from a foreign corporate principal in a real estate transaction would or should know that his or her principal was in fact foreign and that any non-foreign affidavit furnished by the foreign corporation was, therefore, false. In a case involving the transfer by a foreign corporation of stock in a domestic corporation that furnishes a false *non-U.S. RPHC* affidavit, it was not Congress' intention that an agent of the foreign corporate transferor be charged with actual knowledge of the non-U.S. RPHC affidavit's falsity, absent actual possession of such knowledge.

A transferor's agent or transferee's agent that does not give the required notice is liable for withholding as if he or she were the transferee, up to the amount of compensation the agent receives in connection with the transaction.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The Act requires withholding at a ten-percent rate by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to amounts in the custody of the partnership, trust, or estate that are attributable to the disposition of a U.S. real property interest and includible in either the distributive share of a foreign partner of the partnership, the income of a foreign beneficiary of the trust or estate, or the income of the grantor or other substantial owner of the trust (under the grantor trust rules of the Code).

Distributions by domestic U.S. RPHCs

The Act generally requires withholding by a domestic corporation that is (or, at any time during the five-year or shorter base period specified in Code section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax required to be withheld is ten percent of the gross amount of the distribution received by the foreign shareholder.

Withholding is not required under this rule when the stock liquidated or redeemed qualifies for the withholding exemption for stock transferred on an established securities market. Stock qualifying for that exemption may not be a U.S. real property interest

and, hence, its surrender may not be a taxable disposition under the FIRPTA rules.

In addition, a qualifying statement granting exemption from withholding under this rule may be requested from the Internal Revenue Service in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when Code section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in Code section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, the related corporate-level dispositions would have been subject to tax; a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the Code section 897(c)(1)(B) rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the section 897(c)(1)(A)(ii) base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under the FIRPTA rules.

Taxable distributions by partnerships, trustees, and executors

The Act requires withholding by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA rules taxing certain partnership, trust, and estate distributions notwithstanding general Code rules. In general, the amount of tax required to be withheld is ten percent of the fair market value of the distributed U.S. real property interest at the time of the distribution.

As drafted, this rule technically would apply only to U.S. real property distributions taxable under regulations promulgated pursuant to Code section 897(g). The statute makes no reference to another Code provision added by FIRPTA—section 897(e)(2)(B)—under which certain partnership, trust, and estate distributions not covered by section 897(g) could be treated as taxable sales by regulation.

Return-filing and remittance of tax

To prevent double taxation, the Economic Recovery Tax Act of 1981 directs a person subject to tax under the FIRPTA rules to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands. A sale of an interest, other than solely as a creditor, in a U.S. RPHC is subject to tax in the United States, while the tax on a sale of an interest in a Virgin Islands real property holding corporation is payable to the Virgin Islands.

Information returns—penalty provision

The FIRPTA information reporting rules include a provision imposing penalties on persons that fail to file required FIRPTA infor-

mation returns and statements (Code sec. 6652(g)). As indicated above, the 1984 Act limited the circumstances under which the Secretary could require information reporting. The Act did not, however, make necessary conforming changes in the penalty provision.

Explanation of Provisions

Corporations making section 897(i) election

Under the bill, a foreign corporation electing under section 897(i) to be treated as a domestic corporation for purposes of FIRPTA's substantive and reporting provisions will be treated as a domestic corporation for purposes of the FIRPTA withholding provisions too.

The bill also provides that the section 897(i) election will be the exclusive remedy for any person claiming discriminatory treatment under a treaty obligation of the United States with respect to the FIRPTA withholding provisions.

Withholding exemptions for transfers of stock in domestic corporations

The bill conforms the non-U.S. RPHC withholding exemption more closely to the underlying substantive tax rule by substituting for it a new "non-U.S. real property interest" exemption to reflect Code section 897(c)(1)(B). Under the bill, withholding is not required on the disposition of an interest (which is an interest other than solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, either that the corporation is not and has not been a U.S. RPHC during the base period specified in Code section 897(c)(1)(A)(ii), or that, as of the date of the disposition, interests in the corporation are not U.S. real property interests by reason of section 897(c)(1)(B). Under section 897(c)(1)(B), interests in a corporation are not U.S. real property interests if the corporation is not holding any U.S. real property interests at the time of the disposition of the corporate interests and if the corporation disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized.

The present law rules governing notice-giving by agents and withholding by agents and transferees in the case of a false non-U.S. RPHC affidavit will control (with the clarification discussed below) in the case of a false non-U.S. real property interest affidavit.

Notice-giving and withholding responsibilities of agents

The bill clarifies that an agent of a foreign corporate transferor of a domestic corporation's stock will not be charged with actual knowledge of the falsity of a false non-U.S. real property interest affidavit (the bill's substitute for the Act's non-U.S. RPHC affidavit) furnished by the domestic corporation, absent actual possession of such knowledge. Thus, no notice-giving or withholding duty will be imposed on such a transferor's agent unless he or she actually knows that the non-U.S. real property interest affidavit is false. An agent of a foreign corporate transferor will be charged with knowl-

edge of the falsity only of a false *non-foreign affidavit* furnished by his or her principal.

It should be noted that, under the bill, unlike the Act, a non-foreign affidavit furnished by a foreign corporation may be valid. This will be the case where the foreign corporation has elected to be treated as a domestic corporation under Code section 897(i) and the corporation provides the transferee with proof of the section 897(i) election in the manner specified in regulations.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The bill modifies the special withholding rule for dispositions of U.S. real property interests by domestic partnerships, trusts, and estates. Under the bill, a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate is to withhold a tax equal to 28 percent of the gain realized on the disposition by the entity of a U.S. real property interest, to the extent that gain is allocable to a foreign partner or foreign beneficiary of the partnership, trust, or estate or, in the case of a trust, is allocable to a portion of the trust treated as owned by a foreign person under the grantor trust rules of the Code. (It is intended that the Secretary of the Treasury will, by regulations, provide an exception from withholding with respect to gain realized on the disposition of a U.S. real property interest by a trust or estate that is currently taxable at the entity level.)

Consistent with the Act's general withholding rule, withholding liability under this special rule, as amended by the bill, is not limited to the gain realized on the disposition that is in the custody of the partnership, trustee, or executor. A partnership, trustee, or executor that does not have sufficient sales proceeds to satisfy its withholding liability (for example, because it mortgaged the disposed-of property on or after acquiring it, or agreed to accept payment for the disposed-of property on an installment basis) may request a qualifying statement from the Internal Revenue Service authorizing it to withhold a lesser amount.

Computing the tax to be withheld as a percentage of gain should, however, result (in many cases) in the collection of an amount of tax that more closely approximates the final tax liability of foreign partners, beneficiaries, and substantial owners than would the amount of tax collected were the tax computed as a percentage of the full amount realized. Withholding on the basis of gain is feasible under this special withholding rule because, unlike the buyer in the usual withholding situation (who may not know the seller's basis), the withholding agent here—a partnership, trustee, or executor—knows what the foreign taxpayer's gain from the disposition will be: the partnership, trustee, or executor itself computes the amount of that gain. The 28-percent withholding rate reflects the maximum 28-percent capital gains rate for corporations—the highest rate at which a foreign partner, beneficiary, or substantial owner could be taxed on its share of the gain from the disposition of a U.S. real property interest by a partnership, trust, or estate.

The bill also clarifies the Secretary's authority to promulgate such regulations as are necessary to provide for withholding with

respect to U.S. real property gains realized by foreign persons through tiers of domestic partnerships or trusts.

These modifications will be effective for dispositions of U.S. real property interests that occur after the day 30 days after the bill's date of enactment.

Distributions by domestic U.S. RPHCs

The bill clarifies that no withholding is required on certain liquidations and redemptions that are not taxed under the substantive FIRPTA rules. It provides that the special rule requiring withholding by domestic U.S. RPHCs (and former domestic U.S. RPHCs) upon the distribution of property in a corporate liquidation or redemption will not apply when interests in the corporation are not U.S. real property interests by reason of Code section 897(c)(1)(B) on the date of the distribution.

As indicated above, section 897(c)(1)(B) excludes from the definition of a U.S. real property interest an interest in a corporation that (1) is not holding U.S. real property interests at the time the corporate interest is disposed of and (2) disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized. If section 897(c)(1)(B) applies to a corporation's stock, a stock interest surrendered in connection with a liquidation or redemption by the corporation is not a U.S. real property interest. Therefore, the surrender of that stock interest is not a taxable disposition under the FIRPTA rules, and withholding on the surrender is inappropriate.

Taxable distributions by partnerships, trustees, and executors

The bill clarifies that a distribution to a foreign person of a U.S. real property interest by a domestic or foreign partnership, trustee, or executor is subject to withholding if such distribution is taxable under any of the substantive FIRPTA rules, not Code section 897(g) only.

Return-filing and remittance of tax

The bill clarifies that persons required to withhold tax under the FIRPTA withholding rules, like persons having substantive FIRPTA tax liability, are to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and are to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands.

Information returns—penalty provision

The bill amends the provision (Code sec. 6652(g)) imposing penalties on persons that fail to file required FIRPTA information returns to conform it with the revised information reporting rules of the Act.

g. Transfers of property to foreign persons pursuant to corporate reorganizations, etc. (sec. 1510(g) of the bill and sec. 367 of the Code)

Present Law

The Act added a rule (Code sec. 367(e)) requiring that a domestic corporation recognize gain on a liquidating distribution of appreciated property to any foreign person, under rules similar to those applicable to transfers to foreign corporations. The rules applicable to transfers to foreign corporations were generally restructured under the Act. The transactions with respect to which Congress intended to require the recognition of gain by a U.S. transferor included certain distributions to foreign persons pursuant to Code section 355 (relating to distributions of stock and securities of controlled corporations). However, because the applicability of section 355 does not depend on whether the distributee is a corporation, section 367(a)(1) does not reach this result. Section 355 transfers are appropriately addressed under section 367(e), which does not look to the corporate status of the transferee, rather than section 367(a), which applies only to transfers to foreign corporations.

Explanation of Provision

The bill provides that transfers of stock by domestic corporations to foreign persons pursuant to Code section 355 (or so much of section 356 as relates to section 355) will give rise to the recognition of gain under Code section 367(e), to the extent provided in regulations. The committee expects that the Secretary will carefully consider the extent to which it is appropriate, in view of the purpose of section 367(e), to require the recognition of gain upon the transfer of the stock of a domestic corporation to foreign persons under section 355.

h. Foreign personal holding companies

U.S. shareholders in a foreign personal holding company are subject to current U.S. tax on their pro rata share of the company's undistributed foreign personal holding company income. The foreign personal holding company rules were enacted (in 1937) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

(1) Same country dividend and interest exception (sec. 1510(h)(1) of the Act and sec. 552 of the Code)

Present Law

The Act provides that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country generally do not count in determining whether the foreign corporation is a foreign personal holding company. The Act does not define related person for this purpose.

Explanation of Provision

For the purpose of the Act's rule excluding same country dividends and interest from the foreign personal holding company calculation, the bill adopts the related party definition of the controlled foreign corporation rules (sec. 954(d)(3)). The bill provides that a person is a related person with respect to a foreign personal holding company if the person is (1) an individual, partnership, trust, or estate which controls the foreign personal holding company, (2) a corporation which controls, or is controlled by, the foreign personal holding company, or (3) a corporation which is controlled by the same person or persons which control the foreign personal holding company. For this purpose, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The bill incorporates certain rules for determining ownership of stock for this purpose.

(2) Interposed foreign entities (sec. 1510(h)(2) of the Act and sec. 551(f) of the Code)

Present Law

The Act added a tracing rule to the foreign personal holding company rules that was intended to make clear that U.S. taxpayers cannot interpose foreign entities (other than other foreign personal holding companies) between themselves and a foreign personal holding company to avoid the foreign personal holding company rules. Under the tracing rule, stock of a foreign personal holding company that is owned by a foreign entity other than another foreign personal holding company is to be considered (for income inclusion purposes) as being owned proportionately by the foreign entity's partners, beneficiaries, or stockholders.

Explanation of Provision

The bill clarifies that the tracing rule applies to all foreign trusts and estates interposed between U.S. taxpayers and foreign personal holding companies.

i. Treatment of certain indirect transfers (sec. 1510(i) of the bill and sec. 1248(i) of the Code)

Present Law

Code section 1248(a) requires gain realized by certain U.S. persons on the disposition of stock in a foreign corporation to be treated as ordinary income to the extent of allocable earnings and profits of the foreign corporation. Under the Act, if shareholders of a U.S. corporation exchange stock in the corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast for purposes of applying section 1248. Because the Act provides that the U.S. corporation is treated as having distributed the stock in the foreign corporation "in redemption" of the shareholder's stock, every indirect transfer could be viewed as a nonliquidating distribution.

The Act also clarified the treatment of subsequent distributions of earnings that resulted in the recharacterization of gain under section 1248. Taxpayers were given an election to apply this provision retroactively to transactions occurring after October 9, 1975.

Section 1248(g) provides exceptions to section 1248(a) for cases in which gain is taxable as ordinary income under other provisions of the Code. Section 1248(g)(2) refers to any gain on exchanges to which section 356 applies. Under section 356, gain is recognized to the extent of nonqualifying consideration received in a reorganization. Section 356 provides that gain is taxable as a dividend if the exchange has the effect of a dividend, but only to the extent of a shareholder's ratable share of accumulated earnings and profits. If the amount of gain exceeds the allocable portion of earnings and profits, the excess is generally taxed as capital gain.

Explanation of Provision

The bill clarifies that an indirect transfer is recast as a distribution in redemption or liquidation, whichever is appropriate. For example, assume that a U.S. corporation ("P") is the sole shareholder of a U.S. holding company ("Holdco"). Holdco owns 100 percent of the stock of a corporation that was organized under the laws of a foreign country ("S"). Holdco merges downstream into S; in the merger P exchanges Holdco stock for stock of S. Under section 1248(i), the transaction is treated as if Holdco distributed the S stock in a liquidating distribution to P. This result occurs because Holdco goes out of existence and the transaction has the economic effect of a liquidation. Under section 1248(f)(2), however, no amount is includible in Holdco's gross income under section 1248(f)(1), because the S stock is distributed to a domestic corporation, P, which is treated as holding the S stock for the period the stock was held by Holdco and which satisfies the prescribed stock ownership requirements with respect to S. Also, no amount is includible in P's gross income under section 332.

The bill extends the period during which the election relating to previously taxed earnings can be made until one year after enactment of the Technical Corrections Act.

The bill also amends section 1248(g)(2) to limit the exception to a shareholder's gain that is characterized as dividend income under section 356.

j. Stapled stock

(1) Collection of tax (sec. 1510(j)(1) of the bill and sec. 269B(b) of the Code)

Present Law

The Act treats a foreign corporation whose stock is stapled to that of a U.S. corporation as a U.S. corporation. That corporation is thus taxable on its worldwide income. It is not clear, in some cases, how the United States would collect the tax due under this rule. The Act requires the Secretary of the Treasury to prescribe such regulations as may be necessary to prevent tax avoidance or evasion through the use of stapled entities.

Explanation of Provision

The bill specifies that the regulations that the Secretary is to prescribe pertaining to stapled entities may include regulations providing that any tax imposed on a foreign corporation that the Act treats as a U.S. corporation may, if that corporation does not pay them, be collected from the U.S. corporation to which it is stapled or from the shareholders of the foreign corporation. For example, assume that all the interests in a foreign corporation are stapled to interests in a U.S. corporation. In that case, regulations may provide that the U.S. corporation is liable for any tax that the foreign corporation does not pay. Alternatively, it could be appropriate to collect the tax from the shareholders of the stapled foreign corporation.

(2) Foreign-owned corporations (sec. 1510(j)(2) of the bill and sec. 269B(b) of the Code)

Present Law

Under the stapled entity rules of the Act, a foreign corporation whose stock is stapled to that of a U.S. corporation is treated as a U.S. corporation, whoever owns the two corporations. However, the purpose of the stapled entity rules was, in general, to prevent avoidance of tax rules that apply to U.S.-controlled foreign corporations.

Explanation of Provision

The bill limits the stapled entity rules treating a foreign corporation as domestic. These rules will not apply if it is established to the satisfaction of the Secretary of the Treasury that both the stapled foreign corporation and the U.S. corporation to which it is stapled are foreign owned. A corporation is foreign owned for this purpose if less than half of its stock, by vote or value, belongs directly or indirectly to U.S. persons.

k. Insurance of related parties by a controlled foreign corporation (sec. 1510(k) of the bill and sec. 954(e) of the Code)

Present Law

U.S. shareholders of controlled foreign corporations are currently taxable on the foreign base company services income of those corporations. Foreign base company services income is income derived in connection with certain services that satisfy a two-pronged test: (1) they are performed for or on behalf of any person related to the controlled foreign corporation and (2) they are performed outside the country under the laws of which the controlled foreign corporation is organized. For the purpose of the first prong of this test, a related person is generally one with more than 50 percent common ownership. The Act amended the second prong of the test in the case of insurance services: if the primary insured is a related person (defined more broadly in this case to include a 10-percent U.S. shareholder and persons related to that shareholder), any services performed with respect to any policy of insurance or reinsurance will be treated as having been performed in the country in

which the risk of loss against which that related person is insured is located. The Act did not amend the definition of related person with respect to the first prong of the test.

Explanation of Provision

The bill makes it clear that there is a single definition of related person for the purpose of determining the amount of foreign base company services income that arises from insurance. In applying the rule that treats income from services performed with respect to insurance or reinsurance for or on behalf of related persons as foreign base company services income (the first prong of the base company services income test), the primary insured will be treated as a related person if it is related within the broad related party rule used specifically for insurance services under the Act—the rule that reaches 10-percent U.S. shareholders and persons related to them.

l. Definition of resident alien (sec. 1510(l) of the bill and sec. 7701(b)(4)(E) of the Code)

Present Law

Resident aliens, like U.S. citizens, are subject to U.S. tax on their worldwide income at the regular graduated rates. The Act provided standards for determining whether a foreign individual is a resident alien for income tax purposes.

Under these standards, an individual who spends substantial time in the United States in any year or over a three-year period is generally a U.S. resident (the "substantial presence test"). Days spent in the United States as an "exempt individual," a term that includes certain teachers, trainees, and students temporarily present in the United States under subparagraphs (F) and (J) of section 101(15) of the Immigration and Nationality Act, do not count as days of U.S. presence under the substantial presence test. However, a teacher or trainee cannot be an exempt individual in a particular calendar year if the teacher or trainee was exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. Thus, foreign teachers and trainees may work as such in the United States during no more than two calendar years in any seven calendar-year period without exposing themselves to possible resident alien treatment under the substantial presence test.

In 1961, to relieve foreign students, teachers, and scholars of U.S. tax liability that had the effect of reducing the value of their stipends while they were in the United States, Congress provided that compensation paid by a foreign employer to a *nonresident* alien individual for the period the individual is temporarily present in the United States as a non-immigrant (under subparagraph (F) or (J) of section 101(15) of the Immigration and Nationality Act) is not subject to U.S. tax (Code sec. 872(b)(3), added by the Mutual Educational and Cultural Exchange Act of 1961). Because foreign teachers and trainees who work as such in the United States during more than two calendar years may become resident aliens under the substantial presence test, some foreign teachers and trainees admitted

to the United States under exchange visitor programs during three or four calendar years whose foreign income would otherwise be exempt from U.S. tax under Code section 872(b)(3) will be subject to U.S. tax on such income received or accrued during their third and fourth calendar years in the United States.

Explanation of Provision

The bill increases the exemption period for teachers and trainees, all of whose compensation would otherwise be exempt from tax under the Mutual Educational and Cultural Exchange Act, to a maximum of four calendar years. Under the bill, days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in Code section 872(b)(3).

11. Compliance Provisions (sec. 1511 of the bill and secs. 6050H, 6050K, 6660, and 7502 of the Code)

Present Law

The Act contained compliance provisions requiring that:

(1) Recipients of mortgage interest report to the payor and the Internal Revenue Service the amount of mortgage interest received;

(2) Information reporting to the Internal Revenue Service and the taxpayers involved be completed on exchanges of certain partnership interests;

(3) Brokers furnish statements of substitute dividend or tax-exempt interest payments;

(4) A penalty be imposed for substantial underpayments of estate or gift taxes attributable to valuation understatements; and

(5) All deposits of $20,000 or more of any tax required to be deposited under the provisions of section 6302(c) of the Code that are made by any taxpayer required to deposit any tax under that section more than once a month must be made by the due date of the deposit, regardless of the method of delivery.

Explanation of Provision

The bill makes the following changes to these compliance provisions:

(1) The bill provides that a cooperative housing corporation must report to both its tenant-stockholder and the Internal Revenue Service on the tenant-stockholder's proportionate share of interest paid to the cooperative housing corporation. The bill also corrects a citation to the Code in the effective date of a related penalty provision.

(2) The bill corrects an internal reference in the provision relating to reporting on exchanges of certain partnership interests.

(3) The bill makes a conforming amendment to section 6678 (relating to penalties for failing to file statements) to include failures to report the substitute payments. The bill also clarifies that the penalty for intentional disregard of the requirement to report these

substitute payments to the IRS is 10 percent of the aggregate amount required to be reported.

(4) The bill provides a cross-reference to the definition of underpayment for purposes of the penalty for valuation understatments with respect to estate or gift taxes.

(5) The bill clarifies that the new deposit rules apply to any taxpayer required, under the provisions of section 6302(c), to deposit any tax under that provision more than once a month.

12. Miscellaneous Reform Provisions

a. Tax benefit rule (sec. 1512(a) of the bill and sec. 1511 of the Code)

Present Law

The Act amended the rules of prior law to more clearly reflect economic reality in applying the statutory tax benefit exclusion. To accomplish this, the Act repealed the prior law "recovery exclusion" concept and provided that an amount is excludible from income only to the extent it did not reduce income subject to tax.

Explanation of Provision

The bill provides that an amount is excludible from income only to the extent that it does not reduce a taxpayer's income tax under chapter 1 of the Code. Thus, where a deduction reduces taxable income but does not reduce tax (because, for example, the taxpayer is subject to the alternative minimum tax), recovery of the amount giving rise to the deduction may be excludible from income under section 111. This amendment is not intended to change the result in the example set forth in the committee reports accompanying the Act.

b. Low interest loans (sec. 1512(b) of the bill and sec. 7872 of the Code)

Present Law

Section 7872 generally provides that certain loans bearing a below-market rate of interest are treated as loans bearing a market rate of interest accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction, e.g., gift, compensation, dividend, etc.

For purposes of determining the appropriate market rate of interest as well as the timing of the deemed transfers, section 7872 distinguishes between demand loans and term loans. As presently provided by section 7872, a demand loan is defined as a loan which is due on demand. A term loan is defined as a loan which is not a demand loan. Section 7872(f)(5) provides that the term demand loan includes (for purposes other than determining the applicable Federal rate) a loan which is not transferable and the benefits of the interest arrangement of which is conditioned on the future performance of substantial services by an individual.

For income tax purposes, in the case of a below-market term loan that is not a gift loan, section 7872 treats the excess of the amount loaned over the present value of all payments due under the loan as having been transferred from the lender to the borrower at the time the loan is made. In the case of a below-market demand loan as well as all gift loans, the deemed transfer occurs at the end of each taxable year and the amount of the deemed transfer is the foregone interest that year.

In applying the prescribed market rate, section 7872 requires semi-annual compounding for non-gift term loans, but does not require semi-annual compounding for gift loans and demand loans.

Section 7872 also provides that withholding by an employer is not required where a deemed payment arising from a below-market *demand* loan is in the nature of compensation. However, there is no similar exception from withholding where a deemed compensation payment arises from a below-market *term* loan.

Under section 7872, a loan to Israel at a below-market rate might be characterized as a loan bearing a market rate of interest accompanied by a non-deductible gift to Israel.

Under section 4941 of the Code, certain so-called acts of self-dealing between a private foundation and a "disqualified person" are subject to penalty excise taxes on the amount involved. Generally, a loan between the foundation and a disqualified person is an act of self-dealing. However, an exception is provided for interest-free loans to the private foundation, provided that the proceeds of the loan are used exclusively for certain designated charitable purposes.

Explanation of Provision

The definitions of term loan and demand loan in section 7872 appear to treat loans with an indefinite maturity as term loans. However, it often is impractical to treat a loan with an indefinite maturity as a term loan, since section 7872 requires the computation of the present value of the payments due under such a loan. Accordingly, the bill grants the Treasury Department authority to treat loans with indefinite maturities as demand loans rather than term loans.

The bill modifies the special provision of section 7872 that treats certain term loans as demand loans for the purpose of determining the timing of deemed interest and compensation payments. Under the bill, a loan would be entitled to such treatment if the benefit of the interest arrangement of the loan is not transferable and is contingent upon the performance of substantial future services by an individual. Thus, if a loan satisfies these conditions, it would receive the special treatment even if the lender or the borrower (or either) could transfer the loan.

The various time value of money provisions of the Code, (including provisions relating to the treatment of below-market term loans), generally require the use of semi-annual compounding in calculating interest. In order to treat all loans consistently, the bill provides that semi-annual compounding will also be required in calculating interest with respect to gift loans and demand loans under section 7872.

The Conference Report to the Act indicated that payments of compensation, deemed to have been made by section 7872, would be subject to the information reporting requirements but not the withholding requirements of the Code. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1017 (1984). The failure to except from the withholding requirements deemed payments of compensation arising from below-market term loans was inadvertent, and the bill corrects this omission.

The bill also provides an exception from section 7872 for certain loans to Israel. The exception is limited to any obligation issued by Israel if (1) all of the proceeds are to be used for essential governmental purposes, (2) the obligation is payable in U.S. dollars, (3) interest is payable on the obligation at an annual rate of not less than 4 percent, and (4) such obligation is part of an issue marketed primarily on grounds of supporting Israel rather than for investment.

Finally, the bill clarifies that Congress did not intend in enacting section 7872 to affect the definition of acts of self-dealing with private foundations.

c. Transactions with related persons (sec. 1512(c) of the bill and sec. 267 of the Code)

Present Law

The Act generally imposes a matching principle by placing taxpayers on the cash method of accounting with respect to the deduction of amounts owed to a related cash-basis taxpayer. In other words, the deduction by the payor is generally allowed no earlier than when the related payee recognizes the corresponding income.

The application of the above described rule is unclear when the related payee is a related foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.

In addition, the Act also generally deferred losses on sales of property between corporations which are members of the same controlled group of corporations. An exception was provided for certain sales of inventory to or from foreign corporations.

Explanation of Provision

The bill directs the Secretary of the Treasury to issue regulations applying the matching principle generally applicable to related party transactions in cases in which the person to whom the payment is to be made is not a United States person. For example, assume that a foreign corporation, not engaged in a U.S. trade or business, performs services outside the United States for use by its wholly owned U.S. subsidiary in the United States. That income is foreign source income that is not effectively connected with a U.S. trade or business. It is not subject to U.S. tax (or, generally, includible in the foreign parent's gross income). Under the bill, regulations could require the U.S. subsidiary to use the cash method of accounting with respect to the deduction of amounts owed to its foreign parent for these services. In the case of amounts accrued to a controlled foreign corporation by a related person, regulations

might appropriately require the payor's accounting method to conform to the method that the controlled foreign corporation uses for U.S. tax purposes.

Regulations will not be necessary when an amount paid to a related foreign person is effectively connected with a U.S. trade or business (unless a treaty reduces the tax). In that case, present law already imposes matching. However, regulations may be necessary when a foreign corporation uses a method of accounting for some U.S. tax purposes (*e.g.*, because some of its income is effectively connected), but when the method does not apply to the amount that the U.S. person seeks to accrue.

The bill also provides that the special exception from section 267 for sales of inventory to or from foreign corporations applies where the party related to the foreign corporation is a partnership.

For transfers after September 27, 1985, the bill provides that the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner. In addition, the bill provides that the deferral provisions of section 267(a)(2) will apply to two partnerships in which the same persons hold a more than 50-percent of the capital interests or profits interests. This rule is intended to replace the rule in the Treasury regulations,[7] which was suggested by the 1984 Committee Reports, relating to transactions between related partnerships with common partners.

A transitional rule is provided for a specified transaction where indebtedness was incurred before January 1, 1984.

d. Federal Home Loan Mortgage Corporation ("Freddie Mac") (sec. 1512(d) of the bill and sec. 246 of the Code)

Present Law

General background

The Act repealed the prior law exemption from Federal income tax of Freddie Mac, effective January 1, 1985. Various transition rules were included to ensure that, to the extent possible, Freddie Mac was subject to tax only on its post-1984 income.

The 12 regional Federal Home Loan Banks, which hold the common stock of Freddie Mac, are themselves exempt from tax; however, the member institutions of the Home Loan Banks are subject to tax.

In a transaction completed in early 1985, Freddie Mac issued a new class of preferred stock in itself to the regional Federal Home Loan Banks, which then transferred the stock to their member institutions. Distributions with respect to this preferred stock will thus be paid directly to the member institutions. The common stock of Freddie Mac continues to be owned by the Federal Home Loan Banks.

Dividends received deduction

The Act allows shareholders of the Federal Home Loan Banks a dividends received deduction for that portion of dividends received

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[7] Temp. Reg. Sec. 1.267(a)-2T(c), Questions 2 and 3.

from a Federal Home Loan Bank which is allocable to dividends paid to the Federal Home Loan Bank by Freddie Mac out of Freddie Mac earnings and profits for periods after December 31, 1984. Special "stacking" rules are included in order that a deduction may be received only with respect to dividends which are properly allocable to post-1984 earnings and profits of Freddie Mac. No dividends received deduction is allowed to member institutions for dividends received from Federal Home Loan Banks which are allocable to Freddie Mac earnings and profits which Freddie Mac accumulated before January 1, 1985 (i.e., prior to the date of taxability).

In addition to these rules, the Act states that, for all income tax purposes, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985. This provision was intended to ensure that the deduction for dividends received by member institutions from the Federal Home Loan Banks would apply only to the extent the dividends are allocable to post-1984 earnings and profits of Freddie Mac (i.e., to Freddie Mac income which has already been subject to tax).

Explanation of Provisions

Dividends received deduction

The bill makes several adjustments in the dividends received deduction for dividends allocable to post-1984 Freddie Mac income.

First, the bill adds an explicit statutory rule stating that no dividends received deduction is to be allowed with respect to dividends paid by Freddie Mac out of earnings and profits accumulated before January 1, 1985 (i.e., the date of taxability). This rule is in addition to the present law rule which denies a dividends received deduction for dividends paid by a Home Loan Bank which are ultimately allocable to pre-1985 Freddie Mac income. Thus, under the bill, dividends received deductions would be limited to amounts allocable to post-1984 (i.e., taxable) Freddie Mac income, both in the case of income distributed via the Federal Home Loan Banks and in the case of any dividends which may be paid directly to Freddie Mac corporate shareholders who are themselves subject to tax (e.g., member institutions which hold Freddie Mac preferred stock). This rule allows a dividends received deduction where necessary to avoid a double corporate-level tax on Freddie Mac income. In conjunction with this amendment, the present law rule under which Freddie Mac is treated as having no accumulated profits as of January 1, 1985, is repealed.

Second, in the case of income distributed via a Federal Home Loan Bank, the bill clarifies that no dividends paid by Freddie Mac may serve as the basis for more than one deduction for dividends received from a Federal Home Loan Bank. This clarification applies both to dividends paid by a Federal Home Loan Bank in different years, or when two or more dividends are paid during the same year.

Third, in the case of dividends paid directly by Freddie Mac to taxable corporate shareholders, the bill permits a deduction for dividends received in 1985, as well as later years. This result would otherwise be prevented by a Code provision which denies dividends

received deductions for one year after the corporation paying the dividend ceases to be tax-exempt (sec. 246(a)(1)).

Tax treatment of preferred stock distribution

The bill provides that, for all purposes under the Code, the distribution of preferred stock by Freddie Mac to the Federal Home Loan Banks in late 1984, and the distribution of such stock by the Federal Home Loan Banks to their member institutions in January, 1985, are to be treated as if they were distributions of money in an amount equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks, followed by the payment of such money by the member institutions to Freddie Mac in return for its stock. Thus, under the special rule, the Federal Home Loan Banks will be treated as receiving cash dividends to the extent that the money deemed received from Freddie Mac is attributable to earnings and profits of Freddie Mac, and the earnings and profits of the Federal Home Loan Banks will be increased by an equivalent amount. The member institutions, in turn, will be treated as receiving cash dividends from the Federal Home Loan Banks, to the extent that the money deemed received from the Federal Home Loan Banks is attributable to earnings and profits of the Federal Home Loan Banks (taking into account the earnings and profits resulting from the distribution from Freddie Mac). Because these dividends are allocable to pre-1985 earnings and profits of Freddie Mac, the member institutions will not be entitled to a dividends received deduction with respect to these amounts.

Under the special rule above, the earnings and profits of Freddie Mac will be reduced by the amount deemed distributed to the Federal Home Loan Banks. If Freddie Mac later makes distributions to the member institutions out of its pre-1985 income, these distributions will be treated as dividends (and will not qualify for a dividends received deduction) to the extent (if any) that pre-1985 earnings and profits of Freddie Mac exceeded the amount deemed distributed at the time of the preferred stock distribution.

e. Personal use property (sec. 1512(e) of the bill and secs. 280F and 4064 of the Code)

Present Law

The Act provided limitations on the maximum amount of investment tax credit and depreciation that a taxpayer may claim with respect to a passenger automobile. The Act also provided that if use in a trade or business of listed property does not exceed 50 percent, no investment tax credit is available, and depreciation must be determined on the straight line method over the earnings and profits life of the property. Listed property is any passenger automobile or other means of transportation, any entertainment, recreation, or amusement property, any computer, or any other property specified in regulations. However, any computer used exclusively at a regular business establishment is not considered to be listed property. Employee use of listed property must be for the convenience of the employer and a condition of employment for the em-

ployee to be able to claim a deduction or credit for the use of listed property.

Explanation of Provision

The bill clarifies the definition of passenger automobile by providing that the weight of the automobile shall not include the weight of the passengers or the weight of any cargo. A similar clarification is made for purposes of the gas guzzler excise tax (sec. 4064 of the Code). The amendment to the gas guzzler tax will not apply to any station wagon if the station wagon is a 1985 or 1986 model manufactured before November 1, 1985, and is originally equipped with more than 6 seat belts.

The bill also clarifies that the requirements that, in order to take a deduction or credit, employee use of listed property be for the convenience of the employer and required as a condition of employment also apply to the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property.

The bill also clarifies that computers eligible for the exception from the definition of listed property must be owned or leased by the person operating the business establishment, in addition to being used exclusively at a regular business establishment. See H. Rep. No. 98-861 (June 23, 1984), p. 1026 (Conference Report).

Finally, the bill provides that, except to the extent provided in regulations, listed property used as a means of transportation (within the meaning of section 280F(d)(4)(A)(ii)) does not include property substantially all the use of which is in the business of providing unrelated persons services consisting of the transportation of persons or property for hire.

B. Technical Corrections to Life Insurance Provisions

1. Certain amounts not less than surrender value of contract (sec. 1521(a) of the bill and sec. 807(c) of the Code)

Present Law

Present law provides that net increases or decreases in reserves and similar items should be taken into account in computing life insurance company taxable income (LICTI). For purposes of computing increases or decreases in life insurance reserves, the amount of the reserve for any contract is the greater of the net surrender value of such contract or a Federally prescribed reserve; the Federally prescribed reserve requires a company to use a particular method, the prevailing State assumed interest rate, and the prevailing commissioner's standard mortality or morbidity table.

Among the items for which increases or decreases are taken into account in computing LICTI are amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve, at the time with respect to which the computation is made, life, accident, or health contingencies. For these purposes, the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit. Present law does not provide that, in computing increases or decreases in amounts discounted at the appropriate rate of interest, the taxpayer can take into account the net surrender value of the contract if such value is higher than the amount discounted at the appropriate rate.

Explanation of Provision

The bill provides that, in computing the increases or decreases of amounts discounted at interest under insurance and annuity contracts, the amount taken into account will in no case be less than the net surrender value of such contract. This correction recognizes that amounts under these contracts discounted at the prevailing State assumed interest rate may in fact yield a reserve item which is less than the net surrender value guaranteed by the contract. The correction will allow the taxpayer to recognize at least their current liability with respect to obligations not involving life, accident, or health contingencies, as represented by its guaranteed net surrender value of a contract, as is the case with respect to life insurance reserves.

With respect to determining what method should be used in computing the Federally prescribed reserves for life insurance contracts, the 1984 Act adopted the provision as it was passed by the

Senate. In explaining this, the Statement of Managers for the Conference Report expanded the explanation previously made in the Senate report with respect to how annuity reserves should be revalued as of January 1, 1984. In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. Thus, in computing any life insurance reserve (including an annuity reserve), a company must take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes. Because there were divergent State views on how CARVM (the reserve method prescribed for annuity contracts) should be interpreted, and there was a possibility that the NAIC would act to resolve State differences by the end of 1984, the Statement of Managers indicated that if the NAIC acted in 1984, their recommendations would be given retroactive effect.

The NAIC did not act to resolve the State differences on how CARVM should be applied. Accordingly, annuity reserves should have been revalued as of January 1, 1984, in accordance with the prevailing State interpretation of CARVM. It is understood that, through 1983, the prevailing State interpretation of CARVM was that annuity reserves could be reduced by the amount of any surrender charges (whether or not such charges were contingent). Thus, it was assumed that, failing action by the NAIC in 1984, annuity reserves would be revalued and computed for tax purposes by taking into account any surrender charges.

2. Clarification of definition of excess interest (sec. 1521(b) of the bill and sec. 808(d)(1) of Code)

Present Law

Under present law, excess interest is defined as any amount in the nature of interest paid or credited to a policyholder in his capacity as such, and determined at a rate in excess of the prevailing State assumed interest rate for such contract.

Explanation of Provision

The bill changes the language of the statute so that excess interest refers to any amount in the nature of interest in excess of the prevailing State assumed rate for such contract. This change is intended to clarify that the term excess interest refers only to the excess amount and not to the entire amount in the nature of interest (including the amount determined at the prevailing State assumed interest rate).

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3. Coordination of 1984 fresh start adjustment with certain accelerations of policyholder dividends deductions (sec. 1521(c) of the bill and sec. 808 of the Code)

Present Law

As under prior law, present law allows a deduction for dividends or similar distributions to policyholders. Present law departs from prior law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of policyholder dividends paid during the taxable year plus the increases (or less the decreases) in the reserves for policyholder dividends that are payable during the year following the taxable year. Under a transitional rule, this change from a reserve to an accrual method was not treated as a change in a method of accounting. Thus, no income or loss was recognized with respect to amounts in existing policyholder dividend reserves, and taxpayers were given a "fresh start" in computing their policyholder dividends deduction.

Explanation of Provision

This "fresh start" was granted with respect to the accounting change for policyholder dividends on the assumption that insurance companies would continue to follow their general business practice in declaring policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. It was understood that, given the general business practices, the present-law change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid.

It appears that by guaranteeing policy dividends on termination (which may not change necessarily the payment date of policy dividends) or by changing the payment date by making policy dividends available upon declaration, a company can accelerate the deduction for approximately one half the policyholder dividends that would have been deducted in the following taxable year if there had been no change in the company's business practices in declaring policy dividends. As a practical matter, the amount of the acceleration of the policyholder dividend deduction might be viewed as restoring a company, in part, to the position it enjoyed under prior law with respect to the timing of the policyholder dividends deduction. The "fresh start" for the change in policyholder dividends accounting was intended to mitigate the detriment caused taxpayers by a statutory change in such accounting; to the extent the detriment caused by the statutory change is mitigated in fact by a company's own changed business practices, the "fresh start" was not intended to give a company additional tax benefits.

For these reasons, the bill adopts a provision that would reduce a company's policyholder dividends deduction by the amount by which the company's policyholder dividends deduction was accelerated because of a change in business practices. This reduction for an accelerated policyholder dividends deduction would be made before any reduction for the ownership differential provision for

mutual life insurance companies and would not exceed on a cumulative basis the amount of the 1984 fresh-start adjustment for policyholder dividends that was enjoyed by the company. Also, the determination of the amount of the accelerated policyholder dividends deduction and the amount of the 1984 fresh-start adjustment will be made with respect to each line of business.

The term "accelerated policyholder dividends deduction" means the amount that would be determined for the taxable year as policyholder dividends paid or accrued, but which would have been determined for a later taxable year under the business practices of the company as in effect at the close of the preceding taxable year. Thus, types of changes in business practices which would result in an accelerated policyholder dividends deduction include guaranteeing of policy dividends on termination for a particular product line or changing the actual payment date of policy dividends (for example, by making such dividends available upon declaration). On the other hand, changes in plans of insurance being sold or the development of new products will not result in an accelerated policyholder dividends deduction. For example, the introduction and sale of a universal life insurance product that credits excess interest to the cash surrender value on a monthly basis and that may depart from prior business practices of selling traditional participating life insurance policies that pay policy dividends at the policy anniversary date is not the type of change in business practice covered by this provision.

Similarly, policyholder dividends paid or accrued on policies issued after December 31, 1983, generally will not produce accelerated policyholder dividends. However, a policy issued after December 31, 1983, in exchange for a substantially similar policy issued before January 1, 1984, shall be treated as if the policy were issued on the date that the original policy were issued. For this purpose, whether policies are substantially similar is determined without regard to the time of accrual of policyholder dividends. Under this rule, an accelerated policyholder dividends deduction will result if a life insurance company exchanges an old policy for a new policy with substantially similar terms, except that the new policy guarantees policy dividends.

The bill specifically provides that this provision does not apply to a mere change in the amount of policyholder dividends. Thus, if a company changed its dividends scale, for example, by increasing the amount of the policyholder dividend over the previous year or by changing the formula for determining amounts of policy dividends to include items not previously considered in determining the amount of policyholder dividends (e.g., capital gains), this provision would not apply to such change in business practices.

The cumulative amount of reduction of a company's policyholder dividends deduction with respect to a particular line of business because of this provision is limited to the 1984 fresh-start adjustment for policyholder dividends with respect to such business. Specifically, the 1984 fresh-start adjustment for policyholder dividends means the amounts held as of December 31, 1983, by the company as reserves for policyholder dividends that were deductible in 1983, less dividends that accrued before January 1, 1984. Also, the adjustment amount will be properly reduced to reflect the amounts of

previously nondeductible policyholder dividends as determined under prior-law section 809(f).

4. Clarification of equity base (sec. 1521(d) of the bill and sec. 809(b) of the Code)

Present Law

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, for mutual companies the amount of the deduction for policyholder dividends is reduced by an amount referred to in present law as the "differential earnings amount." This reduction reflects the Congress's recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners. The differential earnings amount is computed by multiplying a company's average equity base for the taxable year by a differential earnings rate.

The term equity base means an amount equal to the statutory surplus and capital of a company plus any nonadmitted financial assets, the excess of statutory reserves over tax reserves, the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

Explanation of Provision

As a clarification, the bill specifically provides that no item shall be taken into account more than once in determining the equity base. This clarification is made to ensure that items which are specifically included in the equity base are not counted a second time because they may be indirectly included under another item which is included in the equity base. For example, deficiency reserves, which are specifically listed in the statute as included in the equity base, could also be included indirectly as part of the excess of statutory policy reserves over tax reserves, which is also specifically included in the equity base.

5. Definition of 50 largest stock companies (sec. 1521(e) of the bill and sec. 809(d)(4) of the Code)

Present Law

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying the company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

Specifically, for taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance

companies for the 3 years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets; for these purposes, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies. However, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies which is then used to index the imputed earnings rate, the Secretary has the authority to omit from such computation companies with aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being or is insolvent).

Explanation of Provision

The bill modifies the authority of the Secretary of the Treasury to issue regulations that would exclude companies from the group that comprises the 50 largest stock companies. Under the bill, any company that has a negative equity base could be excluded from the 50 largest stock companies. In addition, regulations could exclude additional companies from the 50 largest stock companies if the exclusion of those companies would, by reason of their small equity bases, seriously distort the stock earnings rate. An unlimited number of stock companies could be excluded from the group by reason of their having a negative equity base. However, at most two companies could be excluded from the group of 50 largest stock companies by reason of the fact that their earnings rate could seriously distort the stock earnings rate. In addition, distorting companies could be excluded from the group of 50 largest stock companies only if their exclusion, in addition to the exclusion for the negative equity companies, would not cause the total number of stock companies to be excluded to exceed two.

6. Clarification of statement gain or loss from operations (sec. 1521(f) of the bill and sec. 809(g)(1) of the Code)

Present Law

Under present law, the earnings rate for any life insurance company is the percentage, determined by the Secretary of the Treasury, which a company's statement gain or loss from operations is of its average equity base. The statutory language under present law states that the term "statement gain or loss from operations" means the net gain or loss from operations required to be set forth in the annual statement (a) determined with regard to policyholder dividends (as defined in section 808) but without regard to Federal income taxes, (b) determined on the basis of tax reserves rather than statutory reserves, and (c) properly adjusted for realized capital gains or losses and other relevant items.

Explanation of Provision

The bill revises the statutory language of the definition of statement gain or loss from operations to make it clear that the term refers to net gain or loss from operations set forth in the annual

statement, determined without regard to Federal income taxes and with further adjustment for certain items. Specifically, the bill clarifies that the "statement gain or loss from operations" must be adjusted by substituting for the amount shown on the annual statement for policyholder dividends the amount of the deductions for policyholder dividends under section 808, unreduced by any differential earnings amount (i.e., without regard to section 808(c)(2)). The use of the tax amount for the policyholder dividends deduction *unreduced* by any differential earnings amount is necessary to eliminate a circularity in computation of the differential earnings amount and to ensure that subsequent adjustments in the differential earnings amount have the revenue impact intended by the ownership differential provision.

7. Effect of differential earnings amount on estimated tax payments (sec. 1521 (g) and (h) of the bill and sec. 809(c) and (f) of the Code)

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying a company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

Specifically, for taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The differential earnings rate for the taxable year will be published by the Secretary of the Treasury after all the relevant data and computations have been made.

The differential earnings amount for any taxable year will be recomputed when sufficient tax return information is available to determine the average mutual earnings rate for the calendar year in which the taxable year begins. Thus, the recomputed differential earnings rate for 1984 will be determined after the tax returns for 1984 are filed, and will be based on the average mutual earnings rate for 1984. If the recomputed differential earnings amount computed with respect to a given taxable year exceeds the differential earnings amount reported on the company's tax return for that year, then the excess is required to be included in taxable income in the succeeding taxable year. Similarly, if the recomputed differential earnings amount computed with respect to a taxable year is less than the differential earnings amount reported for that year, then the difference will be allowed as a deduction in the subsequent taxable year.

Explanation of Provision

The bill amends the definition of the differential earnings rate to be used for a taxable year for purposes of estimated tax payments. Specifically, the bill provides that if, with respect to any installment of estimated tax, the most recent published differential earnings rate is less than the differential earnings rate applicable to the taxable year for which the installment is paid, for purposes of applying additions to tax for underpayments of estimated tax with respect to such installment, the amount of tax shall be determined by using the most recent published differential earnings rate. The "most recent published differential earnings rate" means the most recent differential earnings rate published by the Secretary of the Treasury, determined as of 30 days before the date prescribed for payment of the installment of estimated tax. In providing this relief from additions to tax for underpayments of estimated tax under these limited circumstances, the bill recognizes that, as a practical matter, Treasury will be unable to collect the data from the previous taxable year and compute the new differential earnings rate for the current taxable year in time for the taxpayer to use that differential earnings rate to make its initial estimated tax payments. A 30-day grace period for using the most recent published differential earnings rate was provided to relieve companies from waiting until the last possible day before filing their estimated tax returns.

The bill also clarifies that the recomputation of the differential earnings amount with respect to any taxable year will not affect the liability for estimated tax payments for the taxable year in which the recomputed amount is included in (or deducted from) income. Thus, a mutual company will compute its tax liability for 1984 by using the statutory transitional differential earnings rate of 7.8 percent. If the recomputed differential earnings rate for 1984 exceeds 7.8 percent, then the company will be required to include in income in 1985 the excess of the recomputed differential earnings amount over the differential earnings amount reported on its tax return. As a practical matter, Treasury will be unable to collect the data for 1984 and compute the 1984 rate before 1986. Accordingly, this excess will not affect the company's estimated tax liability, or penalties relating to that liability, for 1985.

8. Amendments related to proration formulas (sec. 1521(i) of the bill and sec. 812 of the Code)

Present Law

Present law retains a prior law concept that items of investment yield should be allocated between policyholders and the company. Because reserve income increases may be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net

investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally all income from investments, including tax-exempt interest, and not including 100-percent dividends except to the extent such dividends are paid directly or indirectly out of tax-exempt income.[8] The net investment income definition as 90 percent of gross investment income was believed to reflect generally the historical level of industry investment expenses.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract for employees not yet retired or to a deferred annuity contract before the annuity starting date; and (4) a fraction (referred to as the "minifraction") of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2), or (3), or any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

The amount of the required interest for reserves is determined at the prevailing State assumed rate. Whether a payment constitutes excess interest is determined by the contract terms. The deductible portion of any policyholder dividend is that portion remaining after a pro-rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable). Finally, the fraction of the deductible portion of policyholder dividends to be included is determined by applying the minifraction. The numerator of the minifraction is gross investment income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2), and (3) described above). The denominator of the minifraction is gross income (including tax-exempt income), less net increases in reserve items.

Explanation of Provision

The bill amends the definition of the company's share of net investment income to clarify that, in arriving at such amount, net investment income should be reduced by all interest paid to a depositor or any customer for the services provided by the life insurance company, whether it is interest guaranteed on the contract (like required interest) or excess interest. For example, net investment income should be reduced by all interest paid on deposit administration contracts which provide no permanent purchase rate guarantees; although the purchaser of such a contract may not technically be a "policyholder," the purchaser may be viewed as a depositor or a customer for the services provided by the life insurance company.

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[8] 100-percent dividends are those which would be eligible for the 100-percent dividends-received deduction, assuming the recipient is not a foreign corporation.

Also, the bill amends the definition of required interest to include not only interest for reserves determined at the prevailing State assumed interest rate, but, where such rate is not used, another appropriate rate.

The bill eliminates a circularity problem existing under the language of present law in determining the minifraction to be used for purposes of computing the gross investment income's proportionate share of policyholder dividends. Specifically, the bill redefines the denominator of the minifraction to be life insurance gross income reduced by the excess (if any) of the closing balance for the reserve items described in section 807(c) over the opening balance for such items for the taxable year. It further generally states that, for purposes of computing the denominator, life insurance gross income shall be determined by including tax-exempt interest and computing any decreases in reserves without any reduction of the closing balance of the reserve items by the company's share of tax-exempt interest.

In addition, the bill refines the definition of net investment income to take into account the fact that investment expenses with respect to assets held in segregated asset accounts have historically been significantly smaller than those with respect to general account assets. Accordingly, in the case of gross investment income attributable to assets held in segregated asset accounts underlying variable contracts, the bill defines net investment income to mean 95 percent of gross investment income.

Finally, for purposes of computing net increases or decreases in reserves and for purposes of the proration formula, the bill provides that the terms "gross investment income" and "tax-exempt interest" shall not include any interest received with respect to a securities acquisition loan (an ESOP loan) as defined in section 133(b) of the Code. Also, for purposes of determining the gross investment income's proportionate share of policyholder dividends, "life insurance gross income" shall not include ESOP loan interest. This amendment more fully implements the intention of Congress when it adopted section 133(b), that is, to encourage financial institutions to make loans to ESOPs.

9. Treatment of foreign life insurance companies (sec. 1521(j) of the bill and sec. 813(a) of the Code)

Present Law

In general, under present law, foreign corporations are subject to U.S. tax only on certain U.S.-source income and on income that is effectively connected with a trade or business conducted in the United States. A foreign corporation carrying on an insurance business within the United States, which would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

A special rule alters the U.S. tax on foreign life insurance companies doing business in the United States if they hold a relatively small surplus attributable to the U.S. business in the United States. If a foreign life insurance company's surplus held in the United States is less than a specified minimum amount, then the company must increase its income by the product of (1) the excess of the required minimum surplus over actual surplus, and (2) its current investment yield.

Explanation of Provision

The bill clarifies how a foreign life insurance company doing business in the United States should compute its life insurance company taxable income if additional income has been imputed because actual surplus held in the United States is less than the required minimum surplus. Specifically, any amount of income imputed by section 813 shall be added to life insurance gross income (before computing the amount of the special life insurance company deduction and the small life insurance company deduction), and such increase in income shall be treated as gross investment income.

10. Treatment of certain distributions to shareholders from pre-1984 policyholders surplus account (sec. 1521(k) of the bill and sec. 815 of the Code)

Present Law

In general, present law eliminated any further deferral of tax through additions to a policyholders surplus account with regard to income for 1984 and later years. Although companies are not able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless such amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules that are comparable to those provided under the 1959 Act, but that reflect the basic changes in the tax structure under the 1984 Act.

Present law provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of distribution. For these purposes, the term distribution includes actual or constructive distributions. See *Union Bankers Insurance Company* v. *Commissioner*, 64 T.C. 807 (1975). When there are distributions from the policyholders surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of amounts in the policyholders surplus account for the benefit of shareholders) is taxed in addition to LICTI and not as part of the LICTI computation. Thus, distributions from the policyholders surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

Explanation of Provision

The citation in the legislative history of the 1984 Act to *Union Bankers Insurance Company* indicated the type of fact situations in

which liability for a phase III tax could arise (i.e., tax on distributions from a policyholders surplus account). The present law emphasis on taxing both direct and indirect distributions from the policyholders surplus account was intended to be construed more broadly than under the 1959 Act, causing certain uses of policyholders surplus account funds to be treated as a distribution therefrom, whether or not there was a distribution specifically under general corporate tax provisions.

The bill includes a statutory clarification as to what would be an indirect distribution from the policyholders surplus account. Specifically, the bill provides that a direct or indirect distribution does not include a bona fide loan with arm's-length terms and conditions. More generally, an indirect distribution will be treated as occurring whenever policyholders surplus account funds are used to benefit the shareholders indirectly. For example, this may occur by using such funds to purchase stock of a parent or an affiliated company or by using such funds to make loans within an affiliated group for less than adequate consideration. Whether or not a loan is made with arm's-length terms and conditions may be determined by reference to section 482 and the regulations thereunder.

In the case of any loan made before September 27, 1985, the amount that will be treated as an indirect distribution from the policyholders surplus account due to the absence of arm's length terms and conditions will be limited to the foregone interest on the loan. The amount of foregone interest will be determined by using the lowest rate which would have met the arm's length requirements for a loan with the same terms and conditions. This rule continues to apply unless the loan is renegotiated, extended, renewed, or revised on or after September 27, 1985.

In addition, the bill provides that the term indirect distribution does not include any transaction involving the purchase of stock by a life insurance company if the stock is preferred as to dividends and mandatorily redeemable by the issuer.

The bill also reinstates a prior law provision (section 819(b)) which provides instructions for distributions from policyholder surplus accounts of foreign life insurance companies doing business in the United States.

11. Treatment of deficiency reserves (sec. 1521(l) of the bill and sec. 816 of the Code)

Present Law

Because of a general change in State law, as well as new rules for computing tax reserves, a prior law provision that specifically excluded deficiency reserves from the definition of life insurance reserves and total reserves was eliminated. Instead, the present law rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.

Explanation of Provision

The bill reinstates the prior-law exclusion of deficiency reserves from the definition of life insurance reserves and total reserves for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign life insurance companies doing business in the United States. This correction is made to clarify that the prior omission was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies. Likewise, this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of any increase or decrease in life insurance reserves.

12. Treatment of certain nondiversified contracts (sec. 1521(m) of the bill and sec. 817(h) of the Code)

Present Law

Present law provides special rules for variable life insurance or annuity contracts, or pension plan contracts with reserves based on segregated asset accounts (generally, all referred to as variable contracts). In addition to the rules for separate accounting with respect to variable contracts, present law grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. Likewise, present law includes specific statutory diversification guidance for segregated accounts that are at least as diversified as regulated investment companies (if no more than 55 percent of assets are held in cash items, government securities, and securities from regulated investment companies), for variable life insurance contracts based on investments in Treasury securities, and for segregated accounts using investment funds that are not available to the public. If a segregated asset account underlying a variable contract does not meet the prescribed diversification standards, the contract will not be treated as an annuity or as life insurance for tax purposes.

Explanation of Provision

The bill clarifies the exception for variable life insurance contracts based on investments in Treasury securities. Generally, to the extent that any segregated asset account with respect to a variable life insurance contract is invested in securities issued by the United States Treasury, the investments made by such account in securities issued by the United States Treasury will be treated as adequately diversified. The committee intends that the Treasury Department, in issuing regulations relating to the adequate diversification requirement, will provide guidance as to how the diversification requirement applies to the assets of the segregated asset account that are not invested in securities issued by the United States Treasury.

In addition, the bill provides that if all the beneficial interests in a regulated investment company or any trust are held by one or

more (a) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (b) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust, the diversification requirements shall be applied by taking into account the assets held by such regulated investment company or trust. This revision of the present law "look through" rule generalizes and broadens the statutory language to allow for the use of seed money, or for the ownership of fund shares by an insurance company or fund manager for administrative convenience, in operating an underlying investment fund.

The committee intends that the types of situations grandfathered in Rev. Ruls. 77-85, 80-274, and 81-225 will continue to be grandfathered under Treasury regulations. Further, the committee expects that the Treasury Department will provide a reasonable time after issuance of regulations relating to the diversification requirement during which an insurance company that relied on private letter rulings issued under the guidelines of those revenue rulings can diversify the assets of a segregated asset account.

13. Treatment of certain deferred compensation plans (sec. 1521(n) of the bill and sec. 818(a)(6)(A) of the Code)

Present Law

Diversification requirements prescribed by Treasury for segregated asset accounts underlying variable contracts do not apply with respect to pension plan contracts. Pension plan contracts refer generally to contracts used for qualified pension plans, individual retirement accounts, or governmental plans which provide retirement benefits.

Explanation of Provision

The bill clarifies the coverage of the term pension plan contract by specifically providing that a governmental plan covered by such term includes a governmental plan within the meaning of section 414(d) or an eligible State deferred compensation plan within the meaning of section 457(b).

14. Dividends within affiliated group (sec. 1521(o) of the bill and sec. 818(e) of the Code)

Present Law

In addition to the general rules applicable to affiliated groups filing consolidated returns, present law provides a specific rule that if an election to file a consolidated return is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

Present law, as adopted under the 1984 Act, omitted a prior-law provision (prior law sec. 818(f)(1)) that provided a special rule for a life insurance company filing or required to file a consolidated

return. Generally, this provision required that a company compute its policyholder's share of investment yield as if such company were not filing a consolidated return.

Explanation of Provision

The bill reinstates the prior-law provision of section 818(f)(1) with minor modifications to reflect changes in the general tax structure recently adopted under subchapter L. Specifically, the bill provides that, in the case of a life insurance company filing or required to file a consolidated return with respect to any affiliated group for any taxable year, any determination under part I of subchapter L with respect to any dividend paid by one member of such group to another member of such group shall be made as if such group was not filing a consolidated return. This reinstatement of the prior-law provision is necessary to maintain the integrity of the proration rule for tax-exempt interest and the intercorporate dividend deduction between policyholders and the company.

15. Treatment of dividends from subsidiaries (sec. 1521(p) of the bill and sec. 805(a)(4) of the Code)

Present Law

In general, the deduction for intercorporate dividends received by a life insurance company is prorated between the company and the policyholders in proportion to the company's share and the policyholders' share of net investment income. However, "100 percent dividends" generally are not subject to proration except to the extent that they are attributable to tax-exempt interest or dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. This limited proration of "100 percent dividends" applies whether the corporation making the distribution were a life insurance company or a corporation not taxed as a life insurance company.

Explanation of Provision

The bill adds a special rule in the case of certain 100 percent dividends received from a life insurance subsidiary. Under the bill, in the case of any 100 percent dividend paid to a life insurance company for any taxable year after December 31, 1983, from another life insurance company, a portion of the deduction under section 243 or 245 (as the case may be) is disallowed if the payor company's share determined under the proration rules exceeds the payee company's share for the payee company's taxable year in which the dividend is received or accrued.

The portion of the deduction that is disallowed is the percentage obtained by subtracting the payee company's share from the payor company's share multiplied by the portion of the dividend attributable to prorated amounts. Prorated amounts include tax-exempt interest income and dividends other than 100 percent dividends. In determining the portion of a dividend attributable to prorated amounts, any dividend by the payor company is treated as coming first out of earnings and profits for taxable years beginning after December 31, 1983, attributable to prorated amounts. In addition,

the portion attributable to prorated amounts is calculated by determining the portion of earnings and profits attributable to prorated amounts without any reduction for Federal income taxes.

16. Special rule for application of high surplus mutual rules (sec. 1521(q) of the bill and sec. 809(i) of the Code)

Present Law

The Act provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds a specified percentage of assets. A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. The amount of any excess equity not taken into account in applying the differential earnings rate will decrease ratably each year, until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate. The amount of excess equity taken into account by any mutual life insurance company for any year (before being phased down ratably over the 5-year period of the transitional rule) cannot exceed the amount of the excess equity determined for 1984.

For purposes of determining whether a company is a high surplus company, the assets taken into account in the equity to asset ratio include all assets (e.g., certain nonadmitted assets) taken into account in determining its equity base including any additional equity attributed to the mutual because of the rules for the treatment of stock life companies owned by mutual life insurance companies. Thus, all the assets of any life insurance subsidiary whose equity is included in equity of the parent mutual company, as well as any assets of separate asset accounts, are included in assets for purposes of applying the high surplus transitional rule.

Explanation of Provision

Under the bill, in the case of any mutual life insurance company that acquired a stock subsidiary during 1982 and whose excess equity base under section 809(i)(2)(D) of the Internal Revenue Code of 1954 is no more than 46 percent of such excess equity base (determined after the application of the provision), the amount of the company's excess equity base for purposes of the high surplus mutual company rule is $122 million. This provision applies without regard to any other provision that would otherwise limit the company's excess equity base.

17. Clarification of denial of fresh-start provisions, application of 10-year spread and the effect of fresh start on earnings and profits (secs. 1522 (a), (d), and (e) of the bill and sec. 216(b)(1) and 216(b)(3) (A) and (C) of the Act)

Present Law

Under the Act, life insurance companies were required to revalue their reserves as of the beginning of the first taxable year beginning after December 31, 1983, according to newly prescribed re-

serve computation rules. Generally, any change in method of accounting or any change in the method of computing reserves which was required by the provisions in the Act was not to be treated as a change in method of accounting or in the method of computing reserves and thus not to give rise to income or loss. This gave life insurance companies a "fresh start" with respect to computing their life insurance reserves.

However, the fresh-start provision did not apply to any reserve transferred pursuant to a reinsurance agreement entered into, or a modification of a reinsurance agreement made after, September 27, 1983 (the date the fresh start provision was announced) and before January 1, 1984 (the effective date of the new provisions). Likewise, the fresh start benefits did not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" included the computation of reserves on contracts issued in 1983 at an interest rate that was lower than the rate normally assumed in computing reserves for similar contracts.

Further, the Act provided that in the case of any item to which the fresh start had been denied, such item should be taken into account for the first taxable year beginning after December 31, 1983 (in lieu of over the 10-year period otherwise provided under present law), unless the item was required to have been taken into account over a period of 10 taxable years under prior law.

Explanation of Provision

The bill clarifies that, with respect to reserves for which the fresh start is denied, the present-law rule for spreading a change in basis of computing reserves over a 10-year period will be applied to the extent that the reserve change would have been required to be taken into account over a 10-year period under prior law. Even with this clarification, with respect to reserves for which the fresh start has been denied, that portion of the reserve change attributable to the repeal of an election under 818(c) is taken into account in the first taxable year beginning after December 31, 1983, and is not spread over a 10-year period.

In addition, the bill conforms the closing date for the period for which proscribed reinsurance transactions will result in a denial of the "fresh start" to that date given for revaluation of reserves. Specifically, it provides that for purposes of the denial of fresh start provision (sec. 216(b)(3)(A) of the 1984 Act), if a reinsurer's taxable year is not a calendar year, "the first day of the first taxable year beginning after 1983" shall be substituted for "January 1, 1984." This is intended to prevent abuse of the fresh-start provisions by use of reinsurance transactions after 1983 where the reinsurer's taxable year may be a fiscal year rather than the calendar year.

The bill clarifies that the change in the insurance company's reserves attributable to the "fresh start" will be taken into account in computing the current and accumulated earnings and profits of the insurance company. Thus, an adjustment to a life insurance company's earnings and profits could be made as of the beginning of the first taxable year beginning after December 31, 1983. Alter-

natively, a company could elect to make the adjustment to earnings and profits as of the beginning of the first taxable year beginning after December 31, 1984.

18. Treatment of certain elections under sec. 818(c) (sec. 1522(b) of the bill and sec. 216(b)(4)(B) of the Act)

Present Law

The Act provided that, except in a limited situation, any election after September 27, 1983, under prior-law section 818(c) to revalue preliminary term reserves to net level reserves shall not take effect. An election under prior-law section 818(c) was allowed to take effect after September 27, 1983, if more than 95 percent of the reserves computed in accordance with such election were attributable to risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

The legislative history describing the denial of fresh start provisions described reserve strengthening as also including generally an election under prior-law section 818(c) which was made after September 27, 1983.

Explanation of Provision

The bill clarifies that a valid prior-law section 818(c) election made under the exception described above shall not be treated as reserve strengthening for purposes of denying a fresh start and requiring that the amount be taken into income in the first taxable year beginning after December 31, 1983. This allows a taxpayer that qualifies for the limited exception for making a prior-law section 818(c) election after September 27, 1983, to have the full benefit of that election.

19. Election not to have reserves recomputed (sec. 1522(c) of the bill and sec. 216(c) of the Act)

Present Law

Under the Act, certain qualified life insurance companies can elect not to recompute reserves for existing contracts as of January 1, 1984, but to use their statutory reserves for all such contracts. In so using statutory reserves for tax purposes, a company elects to forego the "fresh start" with respect to the difference between statutory reserves and the Federally prescribed reserves; there is still a "fresh start" with respect to the difference between statutory reserves and prior law tax reserves attributable to a prior law 818(c) election.

Also, as a transitional rule, any company that makes the above described election and that has tentative LICTI for its first taxable year after 1984 of $3 million or less may further elect to have the reserve for any contract issued on or after 1983 and before January 1, 1989, be equal to the statutory reserve for the contract computed for tax purposes with an adjustment similar to the geometric Menge formula under TEFRA (sec. 805(c)(1) of prior law as in effect for 1982 and 1983).

These elections must be made at the time and in the manner prescribed by Treasury and, once made, are irrevocable.

Explanation of Provision

The provision in the bill makes it clear that in determining whether a company is eligible to make the election for contracts issued on or after 1983 and before January 1, 1989, a company must compute its tentative LICTI taking into account reserves as though the election was in effect. The bill also clarifies that the so-called geometric Menge adjustment should be applied to opening and closing statutory reserves, for purposes of computing net increases or decreases in life insurance reserves.

In addition, the bill provides that the reserve for a company making the election will be the greater of the company's statutory reserve (as adjusted by the geometric Menge adjustment) or the net surrender value of the contract.

20. Special rule for companies using net level reserve method for noncancellable accident and health insurance contracts (sec. 1523 of the bill and sec. 217(n) of the Act)

Present Law

The present-law provision in the Act states that a company shall be treated as meeting the requirements of the Federally prescribed reserve method with respect to any noncancellable accident and health insurance contract for any taxable year if such company (1) uses the net level reserve method to compute its tax reserves on such contracts for such taxable year, (2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and (3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

In explaining this special rule, the Statement of Managers for the Conference Report for the 1984 Act stated that a company can use the net level reserve method for tax purposes for noncancellable accident and health contracts sold under a particular plan of insurance, if the company computed all its reserves for such contracts on that method for statutory purposes as of December 31, 1982, (as evidenced by its 1982 annual statement, as originally filed) and continues to do so for all such reserves on both new and existing business.[9] If the company was not using a net level reserve method as of the prescribed date, with respect to contracts sold under a particular plan of insurance, the company must use the generally prescribed reserve method (2-year full preliminary term method) for all contracts under the plan. Likewise, the generally prescribed method must be used for noncancellable accident and health insurance contracts sold under any new plans of insurance. The explanation in the Statement of Managers limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under

[9] The Statement of Managers erroneously refers to 1983 in describing this part of the provision.

new plans of insurance. The practical consequences of this limiting language is that no company, even one meeting the otherwise strict qualification requirements, will elect to use the special rule because the detriment of foregoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments.

Explanation of Provision

The special rule described above was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that has been predominantly a writer of noncancellable accident and health insurance and that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes. It was intended to allow such company to use this more conservative reserve basis for tax purposes.

Because the rule under present law is impractically narrow, and would not result in any taxpayer making the election, the bill expands the coverage of the rule to allow the net level reserve method for tax purposes on any directly written noncancellable accident and health insurance contract, whether under existing or new plans of insurance. For purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts will be taken into account because, as a reinsurer, a company would generally adopt the reserve method used by the ceding company. This limited expansion will allow the special rule to have its intended practical effect.

Although present law requires that all reserves for noncancellable accident and health insurance contracts be computed on a net level basis for statutory purposes as of December 31, 1982, the bill adopts a *de minimis* margin for error for purposes of administrative convenience. Accordingly, in order to qualify for the application of this rule, a company must have been using the net level reserve method to compute at least 99 percent of its statutory reserves for directly written noncancellable accident and health insurance contracts as of December 31, 1982, and for the 1982 calendar year must have received more than half its premium income from directly written noncancellable accident and health insurance. After December 31, 1983, the company will be treated as using the prescribed reserve method for a taxable year if through such taxable year, the company has continuously used the net level method for computing at least 99 percent of its tax and statutory reserves on its directly written noncancellable accident and health contracts. This requires a complete and continuous use of the net level method for tax and statutory purposes for all but one percent of directly written noncancellable accident and health contracts;

for contracts for which the company does not use the net level method, the company should use the method used for statutory purposes, for purposes of computing tax reserves.

21. Underpayments of estimated tax (sec. 1524 of the bill and sec. 218 of the Act)

Present Law

Under present law, no addition to tax shall be made under the provision relating to failure by a corporation to pay estimated tax with respect to any underpayment of an installment required to be paid before the date of enactment of the Act to the extent that such underpayment was created or increased by any provision of the insurance tax subtitle and such underpayment is paid in full on or before the last date prescribed for payment of the first installment of estimated tax required to be paid after the date of the enactment of the Act. The title of section 218 of the Act was "Underpayments of Estimated Tax for 1984."

Explanation of Provision

The bill repeals section 218 of the Act in favor of the application of the broader general relief granted by section 1479 of this bill. Section 1479 of the bill provides generally that no addition to tax shall be made for underpayments of estimated tax by corporations for any period before March 16, 1985 (by individuals, for any period before April 16, 1985), to the extent that such underpayment was created or increased by a provision of the 1984 Act.

22. Definition of life insurance contract; computational rules (sec. 1525(a) of the bill and sec. 7702(e)(1) of the Code)

Present Law

Under present law, a life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternative tests; (1) a cash value accumulation test, or (2) a test consisting of a guideline premium limitation requirement and a cash value corridor requirement. Under the cash value accumulation test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Under the guideline premium limitation/cash value corridor test, a contract will continue to be treated as life insurance so long as it does not violate its guideline premium limitation or the cash value corridor. A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. Under both tests, present law prescribes minimum interest assumptions and mortality assumptions that must be taken into account in computing the limitations.

In addition, present law provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These computational rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation tests) or the allowable funding pattern (under the guideline premium limitation). First, in computing the net single premium (under the cash value accumulation test) or the guideline premium limitation for any contract, the death benefit generally is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated the same way). Second, the maturity date, including the date on which any endowment benefit is payable, shall be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. Third, the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date described in the second computational rule) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

Explanation of Provision

The bill clarifies the second computational rule by specifically stating that the maturity date shall be *deemed to be* no earlier than age 95 and no later than age 100. This conforms the language of the second computational rule to that of the first and third.

The bill also adds an additional computational rule which provides that for purposes of applying the second computational rule and for purposes of determining the cash surrender value on the maturity date under the third computational rule, the death benefits shall be deemed to be provided until the maturity date described in the second computational rule. This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

23. Reduction in future benefits (sec. 1525(b) of the bill and sec. 7702(f)(7) of the Code)

Present Law

Under present law, proper adjustments must be made for any change in the future benefits or any qualified additional benefit (or any other terms) under a life insurance contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of the contract can occur at the behest of the company or the policyholder or by the passage of time. However, proper adjustments may be made for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease of future benefits.

In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed

by treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed under present law. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent) the change will require an adjustment in the new computation of the net single premium definitional limitation. Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date of issue only with respect to the changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or changes initiated by the company. If the contract fails to meet the limitations after proper adjustments have been made, a distribution of cash to the policyholder may be required in order to maintain qualification of the contract as life insurance.

Under present law, the Secretary of the Treasury has authority to prescribe regulations governing how such adjustments in computations of the definitional limitations should be made. Such regulations may revise, prospectively, some of the adjustment rules described above in order to give full effect to the intent of the definitional limitations.

Further, for the purpose of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under section 1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1031. This provision was intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with limited increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to a policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract.

The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts and only applies with respect to such changes in contracts issued after December 31, 1984. Likewise, this adjustment provision was not intended to repeal indirectly the application of section 72(e) to life insurance contracts.

Explanation of Provision

The bill modifies the provision of present law that governs how adjustments of future benefits will be treated under section 7702. The bill retains the requirement that, in determining whether the contract continues to qualify as life insurance, proper adjustments be made when future benefits are changed. However, the express delegation of authority to the Secretary of the Treasury to issue

regulations governing adjustments has been deleted. In its place, the bill contains specific rules governing the extent to which a reduction in future benefits will cause income to be recognized to the policyholder.

Specifically, the bill provides that if there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under the definitional section, there shall be proper adjustments in future determinations made under the definitional section. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount determined under the adjustment regulations for purposes of enabling the contract to meet the applicable definitional test; a portion of the distribution required by application of the definitional tests will be taxed as ordinary income to the extent there is income in the contract.

In stating the "income characterization" portion of the adjustment provision, the bill refers directly to the provisions governing the taxation of distributions from annuity and life insurance contracts, pointing out that the provision which allows withdrawals from life insurance contracts to be treated as withdrawal of investment first does not apply under certain circumstances.

Under the bill, a portion of the cash distributed to a policyholder as a result of a change in future benefits will be treated as being paid first out of income in the contract, rather that as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

For the first five years following the issuance of the contract, the maximum amount that could be treated as having been paid first out of income in the contract will be equal to the amount of the required distribution under subparagraph (A) of section 7702(f)(7). This amount will depend on whether the contract meets the cash value accumulation test or the guideline premium/cash value corridor test of section 7702(a). Under the cash value accumulation test, the excess of the cash surrender value of the contract over the net single premium determined immediately after the reduction shall be required to be distributed to the policyholder. Under the guideline premium/cash value corridor test, the amount of the required distribution is equal to the greater of (1) the excess of the aggregate premiums paid under the contract over the redetermined guideline premium limitation, or (2) the excess of the cash value of the policy over the redetermined cash value corridor. The guideline premium limitation shall be redetermined by using an "attained-age-decrement" method.

Under this method, when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits, produces an insur-

ance contract with the same benefit as the original contract before such reduction.

To the extent that the redetermined guideline premium limitation requires a distribution from the contract, the amount of the distribution will also be an adjustment to premiums paid under the contract (within the meaning of sec. 7702(f)(1)(A), to be specified in regulations). It is understood that any adjustments to premiums paid as part of the definitional determinations will be independent of, and may differ in amount from, the determination of investment in the contract for purposes of computing the amount of income in the contract (under sec. 72).

For cash distributions occurring between the end of the fifth year and the end of the fifteenth year from the issuance date of the policy, a single rule applies for all contracts. Under this rule, the maximum amount that will be treated as paid first out of income in the contract will equal the amount by which the cash surrender value of the contract (determined immediately before the distribution of the cash to the policyholder) exceeds the maximum cash surrender value that would not violate the cash value corridor (determined immediately after the reduction in benefits).

The bill also provides that certain distributions of cash made in anticipation of a reduction in benefits under the contract shall be treated as a cash distribution made to the policyholder as a result of such change in order to give full effect to the provision. Any distribution made up to two years before a reduction in benefits occurs will be treated as having been made in anticipation of such a reduction. The Secretary of the Treasury is authorized to issue regulations specifying other instances when a distribution is in anticipation of a reduction of future benefits. In addition, these regulations may specify the extent to which the rules governing the calculation of the maximum amount that will be treated as paid first out of income in the contract will be adjusted to take account of the prior distributions made in anticipation of reduction of benefits.

Finally, the bill modifies the definition of the term "premiums paid." Under the bill, premiums paid would be computed in the same manner as under present law, except that the premiums actually paid under the contract will be further reduced by amounts treated as paid first out of income in the contract under the revised adjustment rule. This reduction in premiums paid is limited to the amounts that are included in gross income of the policyholder solely by reason of the fact that a reduction in benefits has been made.

24. Treatment of contracts that do not qualify as life insurance contracts (sec. 1525(c) of the bill and sec. 7702(g) of the Code)

Present Law

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for the taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract is the amount by which the sum of the increase in the net

surrender value of the contract during the taxable year and the cost of insurance protection provided during the taxable year exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amount paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply.

Explanation of Provision

Under the bill, income in the contract is computed without reduction by the amount of policyholder dividends paid under the contract during the taxable year. This change was necessary to avoid overstating the income in the contract, which otherwise would occur due to the fact that policyholder dividends that are treated as a nontaxable return of basis under section 72(e) and reduce premiums paid directly. If these dividends were also added to the amount of income on the contract, income would be overstated.

25. Treatment of contracts issued during 1984 which meet new requirements (sec. 1525(d) of the bill and sec. 221(d)(1) of the Act)

Present Law

Under the Act, the new definition of life insurance generally applies to contracts issued after December 31, 1984, except in the case of certain increasing death benefit contracts issued after June 30, 1984. Also, the TEFRA provisions for flexible premium contracts (that is, prior-law sec. 101(f) applicable during 1982 and 1983) were extended through 1984.

Explanation of Provision

The bill clarifies the definition of life insurance transition rules so that any contract issued during 1984 which meets the definitional requirements of present-law section 7702 will be treated as meeting the requirements of prior-law section 101(f), which was extended through 1984.

26. Treatment of certain contracts issued before October 1, 1984 (sec. 1525(e) of the bill and sec. 221(d)(2)(C) of the Act)

Present Law

Under the Act, a transition rule was provided for certain increasing death benefit policies. This rule made the new definitional provisions of section 7702 applicable only for a contract issued after September 30, 1984, if (1) the contract would meet the new definition by substituting 3 percent for 4 percent as the minimum interest rate in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of a contract can be determined without regard to any mortality charges), and (2) if the cash surrender value of the contract did not at any time exceed the net single premium which would have to be paid at such time to fund

future benefits at the then current level of benefits (with the same 3 percent for 4 percent substitution).

Explanation of Provision

The bill clarifies the transition rule so that in applying the cash value accumulation test by substituting 3 percent for 4 percent as the minimum interest rate, the taxpayer should not only assume that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, but should also assume that the rate or rates should be determined without regard to any initial interest rate guaranteed in excess of the stated minimum rate.

27. Amendments related to annuity contracts (sec. 1526 of the bill and sec. 72(q) and (s) of the Code)

Present Law

Under present law, cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of a contract (determined immediately before the amount was received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made on or after August 14, 1982. The penalty is not imposed if the distribution is made after the contractholder attains age 59-1/2, when the contractholder becomes disabled, upon the death of the contractholder, or as payment under an annuity for life or at least 5 years.

An annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes. These distribution rules generally conform to those applicable to qualified pension plans and IRAs. To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution in effect. If the contractholder dies before the annuity starting date, the entire interest generally must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within one year after the date of death. For these purposes, the "beneficiary" is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.

If there is a spousal beneficiary, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder upon the contractholder's death. Thus, a spousal beneficiary steps into the shoes of the decedent contractholder.

To the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions apply only to individual contractholders or owners of annuity contracts.

Explanation of Provision

The bill makes it clear that the requirement that the annuity contract include required distribution provisions in order to be treated as an annuity need not be met by contracts which are used as part of a qualified pension plan or for an IRA by adopting a specific statutory exemption for these purposes. This provision is added because annuity contracts provided under a qualified pension plan or an IRA must satisfy the required distribution rules applicable to such plans.

In addition, the bill includes special rules to clarify the application of the required distribution rules if the contractholder is not an individual. Specifically, if the contractholder is not an individual, the primary annuitant shall be treated as the holder of the contract. For these purposes, the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the pay-out under the contract. For example, the primary annuitant would be that person referred to in the contract as the measuring life for the annuity starting date or for annuity benefits payable under the contract. Likewise, the bill clarifies the application of the penalty exception for distributions at death so that the penalty does not apply to any distribution made on or after the death of the contractholder or, if the contractholder is not an individual, the death of the primary annuitant. Thus, the additional income tax on early withdrawals is not imposed on a distribution required under section 72(s).

The rules relating to nonindividual contractholders also apply to individuals who are acting in a representative capacity, such as custodians and trustees.

The bill also adds a provision which states that if an individual who holds an annuity contract transfers it by gift or, in the case of a holder which is not an individual, if there is any change in the primary annuitant, then such transfer or change shall be treated as the death of the holder. This correction is made in order to implement fully the forced distribution rules adopted under the 1984 Act, which were intended to terminate deferral allowed in annuity contracts when such contracts were no longer required as a retirement vehicle for the contractholder who was enjoying the tax deferral on the income accumulating in the contract. Without the correction covering gratuitous transfers of annuity contracts, the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer. There is an exception to the rule for transfers of annuity contracts by gift where the transfer is made to a spouse. Specifically, a distribution of the entire interest in the contract will not be required with respect to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

In addition, the bill addresses the problem of how joint contractholders should be treated when one holder dies and clarifies that the forced distribution requirements adopted in the 1984 Act apply upon the death of any holder to such contract.

In order to allow annuity writers time to make changes conforming to the clarifications contained in this bill, these provisions shall

apply to contracts issued after the date which is 6 months after the date of enactment of the technical corrections bill.

Finally, the bill provides that any annuity used as a qualified funding asset in a structured settlement will not be subject to the 5 percent penalty imposed on the portion of any premature distribution from an annuity that is included in gross income.

28. Amendments related to group term insurance (sec. 1527 of the bill and secs. 79 and 83(e) of the Code)

Present Law

Under present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost of $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. The $50,000 cap on the group-term life insurance exclusion is applicable to active employees and to employees who have terminated their employment because of retirement; it does not apply to employees who have terminated employment because of disability. Generally, the cost of group-term life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee at actual cost. For these purposes, the term employee includes all former employees.

Explanation of Provision

The bill provides that, in the case of a discriminatory plan, the cost of group-term life insurance on the life of any key employee shall be the greater of the actual cost of the insurance or the cost determined based on the uniform premium table. The present-law requirement that key employees include in gross income the actual cost of their coverage under discriminatory plans was intended to discourage further the use of discriminatory group-term life insurance plans. This requirement would only tend to have this effect if the actual cost exceeds that specified in the uniform premium table. The technical correction adopted in the bill was intended to give full effect to the prior Congressional intent to not create situations which encourage discrimination (i.e., when the actual cost may be less than that specified in the uniform premium table). Likewise, the bill revises the definition of key employee to include any retired employee if such employee, when he retired, was a key employee. For purposes of applying the nondiscrimination requirements of the group-term life insurance provisions, the bill also clarifies that, to the extent provided in regulations, coverage and benefit tests may be applied separately to active and former employees.

In addition, the bill makes a clerical correction to section 83(e)(5), which coordinates that section with section 79. Section 83(e)(5) presently excepts *the cost of* group-term life insurance to which section 79 applies from the application of section 83 (governing the taxation of property transferred in connection with performance of services). The bill provides that section 83 shall not apply to group-term life insurance covered by section 79. Thus, when an employee retires, the present value of any future group-term life insurance coverage which may become nonforfeitable upon retirement (or the value of an amount set aside by an employer to fund such coverage) will not be taxed immediately to the employee upon retirement. Rather, if the coverage constitutes group-term life insurance within the meaning of section 79 (e.g., the employee does not receive a permanent guarantee of life insurance coverage from the insurance company), the cost of the coverage will be taxable annually to the retired employee under section 79. This rule also applies in the case of an employee who separates from service with a vested right to continuing group-term life insurance coverage.

Finally, the bill clarifies the effective date of the present-law provisions which were adopted in the 1984 Act by providing that the extension of the $50,000 cap to retired employees and the extension of the nondiscrimination provisions to former employees do not apply to any group-term life insurance plan of the employer in existence on January 1, 1984, but only with respect to an individual who attained age 55 on or before January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983. The 1984 Act amendments also shall not apply to any employee who retired from employment on or before January 1, 1984, and who, when he retired, was covered by a group-term life insurance plan of the employer (or a predecessor plan).

The provision relating to the determination of costs with respect to key employees in a discriminatory plan is effective for taxable years ending after the date of enactment of the bill.

29. Amendment related to certain exchanges of insurance policies (sec. 1528 of the bill and sec. 1035(b) of the Code)

Present Law

Under present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or an annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date, or for an annuity contract; or (3) an annuity contract for an annuity contract. For purposes of this exchange rule, an endowment contract and a life insurance contract are defined to include contracts issued by any insurance company taxable under subchapter L of the Code. This change in law effective in 1984 was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract.

Explanation of Provision

The bill amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code. This provision applies to exchanges occurring before, on, or after the date of enactment of the technical corrections provision.

30. Waiver of interest on certain underpayments of tax (sec. 1529 of the bill)

Present Law

Interest on an underpayment of tax generally is payable from the due date of the return (determined without regard to extensions).

Explanation of Provision

The bill provides that no interest shall be payable for any period before July 19, 1984, on any underpayment of tax imposed by the Internal Revenue Code, to the extent such underpayment was created or increased by any provision of subtitle A of title II of the Tax Reform Act of 1984.

C. Technical Corrections to Private Foundation Provisions

1. Reduction in section 4940 excise tax where charitable payout meets certain distribution requirements (sec. 1532 of the bill and sec. 4940 of the Code)

Present Law

Under section 303 of the Act, the rate of the excise tax imposed on the net investment income of a private foundation (Code sec. 4940) is reduced for a taxable year from two percent to one percent if the amount of qualifying distributions made by the foundation during that taxable year equals or exceeds the sum of (a) an amount equal to the foundation's assets for such taxable year multiplied by the average percentage payout for the base period, plus (b) one percent of the foundation's net investment income for such taxable year. However, the reduction is not available for a year if the foundation's average percentage payout for the base period is less than five percent, or 3-1/3 percent in the case of a private operating foundation (Code sec. 4940(e)(2)(B)). The reduction in the section 4940 tax rate is effective for taxable years beginning after 1984.

Explanation of Provision

The bill modifies the rule disqualifying certain foundations from the section 4940 rate reduction, to provide that the rate reduction is not available if the foundation was liable for tax under section 4942 with respect to any year in the base period.

This modification effectuates the intended rule that a foundation which failed in any base period year to make the minimum required expenditures for charitable purposes should not be eligible to obtain the benefit of tax reduction merely by increasing its qualifying distributions (in an amount at least equal to one percent of net investment income) up to the minimum section 4942 level. As a result of the modification made by the bill, a nonoperating foundation will not be disqualified from the rate reduction in two situations where the foundation does not incur liability for section 4942 taxes even though the amount of its qualifying distributions (sec. 4942(g)) does not equal at least five percent of its assets. The first situation results from the fact that under section 4942(d), the distributable amount equals the minimum investment return (five percent of assets) reduced by the sum of any taxes imposed on the foundation for the taxable year under section 4940 and the unrelated business income tax. The second situation results from the fact that under section 4942(i), the distributable amount is further reduced by the amount of any excess distributions carryovers from a prior year. However, since neither the amount of such taxes nor the amount of such carryover distributions is included in the defi-

nition of qualifying distributions in section 4942(g), a foundation whose distributable amount is reduced by such taxes or carryover excess distributions does not incur section 4942 tax liability if the amount of its qualifying distributions, while less than the minimum investment return, equals or exceeds the distributable amount as thus computed. At the same time, the technical amendment made by the bill precludes any reduction in the section 4940 tax if, with respect to any base period year, the foundation is liable for tax under section 4942 for failure to satisfy the minimum distribution requirements.

2. Exemption for certain games of chance (sec. 1533 of the bill and sec. 513 of the Code)

Present Law

Section 311 of the Act provides that, for purposes of Code section 513, the term unrelated trade or business does not include any trade or business that consists of conducting a game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game by such organization does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization (i.e., the conducting of the game of chance by other than nonprofit organizations would violate the State law). This provision applies to games of chance conducted after June 30, 1981.

Explanation of Provision

The bill clarifies that the only State law to which the provision is intended to apply is a North Dakota law originally enacted on April 22, 1977.

D. Technical Corrections to Tax Simplification Provisions (secs. 1541-1549 of the bill)

Present Law

The Act contained a title which added a number of provisions intended to simplify and improve the laws. These included provisions related to the individual estimated tax, domestic relations, at-risk, administrative provisions, distilled spirits, the Tax Court, income tax credits and deadwood.

Explanation of Provision

The bill makes numerous nonsubstantive clerical and conforming amendments to these provisions.

The bill restores two provisions of prior law which were inadvertently changed by the Act. First, certain non-resident aliens will continue to be required to make estimated tax payments in three, rather than four, installments. One-half of the estimated tax will be due with the first payment. Second, the principles of prior law relating to the carryover of credits (including the foreign tax credit) by taxpayers subject to the alternative minimum tax are restored. The conforming amendment relating to the foreign tax credit will apply to taxable years beginning after December 31, 1982 (the effective date of the changes to the minimum tax made by TEFRA).

The bill also amends the domestic relation provisions to provide that alimony payments under certain support decrees (described in section 71(b)(2)(C)) will not be disqualified solely because the decree does not specifically state that the payments will terminate at the payee's death. In addition, the bill clarifies that in the case of the transfer of property to a trust for the assumption of (or subject to) liabilities in excess of basis, gain will be recognized to the extent of such excess notwithstanding section 1041(a). Gain will also be recognized on the transfer of installment obligations to a trust.

Finally, the bill permits taxpayers to be represented in the Tax Court in small tax cases by certified public accountants and enrolled agents who are authorized to practice before the IRS, regardless of whether such persons have been admitted to practice before the Tax Court by passing the Court's examination.

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E. Technical Corrections to Employee Benefit Provisions

1. Funded Welfare Benefit Plans (sec. 1451 of the bill and secs. 419, 419A, 505, 512, and 4976 of the Code)

Under the Act, the amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The Act defines the qualified cost of a welfare benefit fund for a year as the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to reserves under the fund for the year (the qualified asset account), reduced by the after-tax income of the fund. The deduction limits do not apply to a 10-or-more employer plan.

a. Definition of fund

Present Law

The Act defines a fund as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust, corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Further, if an employer contributes amounts to an insurance company for benefits and under that arrangement the employer is entitled to a rebate if the amount paid exceeds benefit claims and is liable if the benefit claims exceed the amount paid, then such contributions are considered to have been made to a welfare benefit fund.

Finally, under current law, an employer is not permitted a deduction for premiums paid on a life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the employer, where the employer is directly or indirectly a beneficiary of the policy (sec. 264(a)(1)).

Explanation of Provision

The bill amends the definition of a "fund" to exclude amounts held under three different types of insurance arrangements: (1) an insurance contract described at Code sec. 264(a)(1); (2) certain "qualified nonguaranteed contracts"; and (3) certain "guaranteed renewal contracts."

First, under the bill, the term "fund" would exclude amounts held by an insurance company pursuant to a life insurance policy on the life of an officer, employee, or person financially interested

in the trade or business of the employer, where the employer is the direct or indirect beneficiary of the policy; these are amounts otherwise subject to sec. 264.

The bill also modifies the term "fund" to exclude amounts held by an insurance company under certain "qualified nonguaranteed insurance contracts." A qualified nonguaranteed, insurance contract is defined under the bill as an insurance contract under which: (1) there is no guarantee of a renewal of the contract, and (2) other than current insurance protection, the only payments to which the employer or employees are entitled under the contract are refunds or policy dividends that are not guaranteed, that are experience rated and that are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries. Thus, under the bill, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to the extent that the amounts are subject to a significant current risk of economic loss that is determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer.

In addition, the bill provides that even an arrangement that satisfies the foregoing description will not be excluded from treatment as a fund, unless the amount of any experience rated refund or policy dividend payable with respect to a policy year is treated by the employer as paid or accrued in the taxable year in which the policy year ends. If the actual amount of the refund or dividend is not known by the due date of the employer's tax return for the year, Treasury regulations could permit the use of a reasonable estimate of the amount of such refund or dividend. In addition, Treasury regulations could require insurance companies to submit information (including proprietary information of the insurance company) relating to the basis for the calculation of experience-rated refunds and policy dividends.

To the extent that the general rules for the exclusion of amounts held by an insurance company are satisfied, amounts held by an insurance company for a reasonable premium stabilization reserve for an employer are not treated as a fund. Thus, a premium stabilization reserve, if limited to a reasonable amount, such as 20 percent of premiums for the year, would not be treated as a fund to the extent that (1) such amounts are subject to a significant current risk of economic loss, and (2) experience rated refunds and policy dividends payable by the reserve with respect to a policy year are treated by the employer as paid or accrued in the taxable year in which the policy year ends.

Solely for purposes of these provisions, the amounts released from a premium stabilization reserve to purchase current insurance coverage are to be treated as experience-rated refunds or policy dividends. Thus, the amounts released from the premium stabilization reserve in a given policy year are to be treated by the employer as paid or accrued in the taxable year in which such policy year ends.

Whether amounts are subject to a significant current risk of loss depends upon the facts and circumstances. For example, if an employer does not have a guaranteed right under an insurance con-

tract to policy dividends based solely on the employer's experience but the insurance company has, in practice, consistently paid such dividends based solely on the employer's experience, it is anticipated that Treasury regulations would provide that the amounts held under the contract constitute a fund because they are not subject to a significant current economic risk of loss.

Finally, the bill clarifies that the definition of a "fund" excludes amounts held by an insurance company pursuant to certain "guaranteed renewal contracts," under which, the employer's right to renew the contract is guaranteed, but the level of premiums is not.

b. Coordination of post-retirement medical benefits with limits on qualified plans

Present Law

Under the provisions of the Act relating to the coordination of net contributions for post-retirement medical benefits with the overall limits on contributions and benefits under qualified pension plans and certain other funded plans deferring compensation (secs. 415(c) and (e)), any amount allocated to a separate account for a key employee is treated as an annual addition to a defined contribution plan. Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee. The 25-percent limit prevents reserve additions for post-retirement medical benefits after the retirement of key employee.

Explanation of Provision

The bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the employee's annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the total annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit of section 415(c) for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits of section 415(e) are satisfied.

The effect of this rule is to permit the funding of post-retirement medical benefits on behalf of a key employee during periods when the employee has no compensation from the employer (e.g., after retirement).

c. Separate accounting required for certain amounts

Present Law

In order to provide an overall limit with respect to pre-retirement deductions for certain post-retirement benefits of key employees, the Act requires separate accounting for contributions to provide post-retirement medical or post-retirement life insurance benefits to an individual who is, or ever has been (after the effective date of the Act), a key employee.

Explanation of Provision

The bill clarifies the requirement for separate accounting with respect to post-retirement medical benefits and post-retirement life insurance benefits. Under the bill, the requirement does not apply until the first taxable year for which a reserve is computed using the special provisions applicable to these benefits. The separate account requirement applies for that first year and for all subsequent taxable years.

d. Reserves for discriminatory post-retirement benefits disregarded

Present Law

Under the Act, no reserve is to be taken into account in computing the account limit with respect to a post-retirement medical benefit or a post-retirement life insurance benefit under a plan that does not meet the nondiscrimination standard provided by the Act (sec. 505). The nondiscrimination standards of the Act do not apply to benefits under certain collectively bargained plans.

Explanation of Provision

The bill provides that no reserve generally may be taken into account in determining the account limit for a welfare benefit fund for post-retirement medical benefits or life insurance benefits (including death benefits) unless the plan meets the nondiscrimination requirements with respect to those benefits (sec. 505(b)), whether or not those nondiscrimination requirements apply in determining the tax-exempt status of the fund. The bar against taking post-retirement medical benefits and life insurance benefits into account in determining the account limit does not apply, under the bill, in the case of a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

The bill clarifies that certain post-retirement group term life insurance benefits that fail to satisfy the nondiscrimination requirements of Code section 505(a) may, nevertheless, be taken into account in determining the account limit to the extent that the group-term life insurance benefits are provided under an arrangement grandfathered under section 223 of the Act.

e. Account limit for life insurance benefits

Present Law

In the case of a life insurance or death benefit, the Act provides that the account limit is not to include a reserve to the extent the reserve takes account of an amount of insurance that exceeds the amount that may be provided to an employee tax-free under an employer's group-term life insurance program (sec. 79). In the case of a self-insured death benefit, the account limit is not to include a reserve to the extent that a benefit would be includible in gross income if the limit on excludible death benefits were $50,000.

Explanation of Provision

The bill clarifies that life insurance benefits are not to be taken into account in determining the account limit under a welfare benefit fund to the extent that the aggregate amount of such benefits to be provided with respect to an employee exceed $50,000. Accordingly, under the bill, the $50,000 limit applies with respect to the aggregate of self-insured and insured life insurance benefits under all funds maintained by the employer. The bill does not change the rules of the Act under which certain post-retirement life insurance benefits in excess of $50,000 may be taken into account in determining the account limit for certain individuals under plans in existence on January 1, 1984 (Act sec. 223(d)(2)).

f. Actuarial certification

Present Law

The Act provides that the account limit for a qualified asset account (reserve) for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid. The time at which claims are incurred is the time at which the employee becomes entitled to the benefits, i.e., the time at which the fund becomes liable for the claims. Under the Act, insurance premiums, whenever payable, are not regarded as claims incurred but unpaid.

Unless there is an actuarial certification with respect to benefits other than (1) post-retirement medical benefits or post-retirement life insurance benefits or (2) supplemental unemployment compensation (SUB) or severance pay benefits, the account limit for a welfare benefit fund is not to exceed certain safe-harbor limits.

Explanation of Provision

The bill provides that the requirement for an actuarial certification also applies to post-retirement medical benefits and post-retirement life insurance benefits, unless a safe harbor computation is used.

g. Aggregation of funds

Present Law

In addition to the limits provided by the Act with respect to post-retirement medical benefits provided under a welfare benefit fund, the Act provided dollar limits applicable to the amount of life insurance benefits and supplemental unemployment compensation benefits or severance pay benefits for which a reserve may be accumulated for any participant. The Act does not specify that these limits apply to the aggregate of reserves under all funds of an employer rather than on a fund-by-fund basis. Also, in the case of life insurance benefits, the Act does not specify that the limit on reserves is to be applied to the aggregate of insured and self-insured benefits.

Explanation of Provision

The bill provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits, and post-retirement life insurance benefits for which reserves may be accumulated for any participant, all welfare benefit funds of an employer are to be treated as a single fund. For example, under the bill, if an employer maintains two or more welfare benefit funds to provide life insurance benefits for a participant, then the $50,000 limit is to be applied with respect to that participant to the aggregate of the group of funds rather than to each separate fund. In the absence of Treasury regulations to the contrary, the limit is allocated proportionately to the amount of the death benefit in each plan.

h. Transition rules

Present Law

The account limit for any of the first four taxable years to which the rules for welfare benefit funds apply is increased, under the Act, by the applicable percentage of any existing excess reserve. In particular, the Act provides that, for the first year, the limit is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the existing excess reserve amount. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively is substituted for 80 percent. The Act does not clearly provide that the existing excess reserve for any year is to be the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year the computation is being made, without regard to the transitional rule.

Explanation of Provision

The bill provides that, under the transition rules for existing excess reserves, the amount of existing excess reserves for any year is the excess (if any) of (1) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits, over (2) the account limit determined under the Act (without regard to the transition rules) for the taxable year for which the excess is being computed. The bill further provides that the transition rule allowing an increase in the account limit because of existing excess reserves applies only to a welfare benefit fund which, on July 18, 1984, had assets set aside to provide the enumerated benefits.

Accordingly, in the case of an employer that maintains a funded plan which had assets set aside to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits on July 18, 1984, and to which the deduction limits first apply for the taxable year beginning January 1, 1986, the increase in the account limit for 1986 attributable to existing excess reserves is 80 percent of the excess, if any, of the amount of assets set aside at the close of 1984 (the first taxable year ending after July 18, 1984) over the account limit determined under the general rules for 1986. For 1987, however, the increase attributable to existing excess reserves is 60 percent of the excess, if any, of the amount of assets set aside at the close of 1984 over the account limit determined for 1987.

i. Tax on unrelated business income

Present Law

Under the Act, the tax on unrelated business taxable income of a social club, VEBA, SUB, or group legal service organization applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes. The limit on the amount that may be set aside for a year is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits provided by the Act.

The limitation on the amount that may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical or post-retirement life insurance benefits. Under the Act, this exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits.

In addition, the Act provides for the inclusion of a similar amount (deemed unrelated income) in the gross income of an employer who maintains a welfare benefit fund that is not exempt from income tax. It is anticipated that Treasury regulations will provide that deemed unrelated income will be treated in a manner that will not subject the same income to tax more than once.

Explanation of Provision

The bill makes it clear that the tax on unrelated business income applies in the case of a 10-or-more employer plan. Under the bill, the account limit is to be determined as if the rules limiting deductions for employer contributions applied.

In addition, the bill clarifies that the transition rule for pre-existing reserves for post-retirement medical and life insurance benefits applies to assets set aside as of July 18, 1984, rather than to assets set aside as of the end of the plan year ending before July 18, 1984.

The bill deletes the provision of the Code barring a set aside for assets used in the provision of permissible benefits (facilities). Treasury regulations are to provide that the value of facilities used to provide permissible benefits is disregarded in determining whether fund assets exceed the account limit for a qualified asset account.

In addition, the bill provides that if any amount is included in the gross income of an employer for a taxable year as deemed unrelated income with respect to a welfare benefit fund, then the amount of the income tax imposed on the deemed unrelated income is to be treated as a contribution paid by the employer to the fund on the last day of the taxable year and, thus, is deductible, subject to the limits on deductions for fund contributions. The tax attributable to the deemed unrelated income is to be treated as if it were imposed on the fund for purposes of determining the after-tax income of the fund.

j. Tax on disqualified benefits provided under funded welfare benefit plans

Present Law

Under the Act, if a welfare benefit fund (other than an arrangement funded exclusively by employee contributions) provides a disqualified benefit during a taxable year, then an excise tax is imposed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

Under the Act, a disqualified benefit is (1) any medical benefit or life insurance benefit provided with respect to a key employee other than from a separate account required under the rules limiting employer deductions with respect to welfare benefit funds, (2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of the nondiscrimination rules of the Act for benefits under a welfare benefit fund, or (3) any portion of a welfare benefit fund reverting to the benefit of the employer. Under the Act, a portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. Also, amounts returned to employees that represent the employees' contributions to the fund are not treated as amounts reverting to the benefit of the employer and, therefore, are not subject to the tax on disqualified benefits.

Explanation of Provision

With respect to benefits required to be paid from a separate account, the bill defines the term "disqualified benefit" to mean any post-retirement medical benefit or post-retirement life insurance benefit provided with respect to a key employee if a separate account is required to be established for the employee and the payment is not from such an account. Accordingly, pre-retirement benefits would not be considered to be disqualified benefits under the bill merely because they are paid to a key employee from a source other than a separate account.

In addition, under the bill, a post-retirement medical benefit or post-retirement life insurance benefit provided by a fund with respect to an individual in whose favor discrimination is prohibited by the Code is a disqualified benefit unless the plan meets the nondiscrimination requirements of the Act with respect to the benefit (sec. 505(b)), whether or not the nondiscrimination requirements apply in determining the tax-exempt status of the fund from which the benefit is provided.

Under the bill if a plan is not exempt from the discrimination rules under the rules for collectively bargained plans, a discriminatory benefit is a disqualified benefit subject to the excise tax even though no discrimination test applies for purposes of determining the exempt status of the fund from which the benefit is provided. A benefit is not subject to the nondiscrimination requirements if it is provided under a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

Further, under the bill, a payment that reverts to the benefit of an employer is not a disqualified benefit to the extent it is attributable to an employer contribution with respect to which no deduction is allowable in the current or any preceding taxable year or to an employee contribution. As under current law, the excise tax on disqualified benefits is inapplicable to welfare benefit contributions funded solely by employees. A reduction is to be made to the amount treated as a carryover (sec. 419(d)) to the extent that any nondeducted contribution reverts to the benefit of an employer. Any amounts reverting to the benefit of an employer are treated as coming first out of nondeducted contributions for purposes of this rule.

Also, the bill provides that a benefit that would otherwise be a disqualified benefit because it does not meet the separate-account rule or because it is discriminatory is not a disqualified benefit if it is a post-retirement benefit that is charged against an existing reserve (or against any income properly allocable to an existing excess reserve) for post-retirement medical or post-retirement life insurance benefits as provided under the transition rules of the Act (sec. 512(a)(3)) applicable to the unrelated business income tax.

k. Effective dates

Present Law

The Act provides that the new limits on deductions under welfare benefit funds generally apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Special effective dates are provided for contributions with respect to facilities and for certain collectively bargained plans. The effective dates for the provisions relating to the tax on unrelated business income and the excise tax on disqualified benefits were unclear under the Act.

Under the Act, a transition rule for existing excess reserves is provided with respect to the account limit for any of the first four years to which the rules for welfare benefit funds apply. The existing excess reserve for any year is the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide such a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year for which the computation is being made, without regard to the transitional rule.

Explanation of Provision

The bill provides that the rules of the Act relating to the tax on disqualified benefits generally apply to benefits provided after December 31, 1985. Under the bill, however, the tax on disqualified benefits does not apply to benefits charged against an existing reserve for post-retirement medical benefits or post-retirement life insurance benefits (as defined under the transition rules (sec. 512(a)(3))) applicable to the unrelated business income tax.

The bill clarifies that the amendments made by the Act with respect to the tax on unrelated business income are effective for taxable years ending after December 31, 1985, and are to be treated as a change in the rate of income tax imposed for purposes of Code section 15.

Further, the committee intends that the transition rule for existing excess reserves first applies to the first taxable year for which the Act is effective. Thus, the phaseout of existing excess reserves does not apply to any taxable year of the fund before the first taxable year to which the Act applies.

2. Transition Rule for Certain Taxpayers with Fully Vested Vaction Pay Plans (sec. 1552(b) of the bill and sec. 512 of the Act)

Present Law

Under the Act, any plan, method, or arrangement providing for deferred benefits for employees, their spouses, or their dependents is treated as a plan deferring the receipt of compensation (deferred benefit plan). The Act provided that a deferred benefit plan includes an extended vacation pay plan, i.e., a plan under which employees gradually, over a period of years, earn the right to additional vacation that cannot be taken until the end of the period. Similarly, a vacation pay plan under which employees can delay

the vacation (and also the income inclusion) beyond the current taxable year is a deferred benefit plan. However, any vacation benefit to which an election applies under section 463 (relating to accrual of vacation pay) is not considered a deferred benefit.

The provision of the Act was effective for amounts paid or incurred after July 18, 1984, in taxable years ending after that date.

Explanation of Provision

The bill provides a transition rule in the case of a fully vested vacation pay plan in which payments are required within one year after the accural of the vacation. If the taxpayer makes an election under section 463 for the taxpayer's first taxpable year ending after July 18, 1984, then, in lieu of establishing a suspense account under section 463, the election is treated as a change in the taxpayer's method of accounting and the adjustments required under section 481 are taken into account.

Under the bill, the time for making a section 463 election is extended to six months after the date of enactment in the case of a taxpayer otherwise eligible for the transition rule.

3. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

a. Distribution rules for qualified plans (secs. 1552(a) and (b) of the bill and secs. 72, 401, 402, 403, and 408 of the Code)

Present Law

Distributions prior to age 59½

Prior to the Act, the Code imposed an additional 10-percent additional income tax on distributions made to key employees in a top-heavy plan prior to age 59½ unless the participant dies or becomes disabled. The Act provided that the additional tax applies to 5-percent owners (rather than key employees), but only to the extent that the distribution is attributable to contributions made or benefits accruing in years in which the participant was a 5-percent owner (as defined in sec. 416(i)).

Before-death distribution rules

The Act amended the minimum distribution rules provide that a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required beginning date. Alternatively, the requirements of the Act may be satisfied if the entire interest is to be distributed (in accordance with Treasury regulations), beginning no later than the required beginning date, over (1) the life of the employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the employee and a designated beneficiary.

Under the Act, the required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (as defined at sec. 416(i))

with respect to the plan year ending in the calendar year in which the employee attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70½, even though the employee has not retired. The Act does not, however, require the distribution to a 5-percent owner of employer securities subject to the 84-month holding period of section 409(d) before the expiration of the 84-month period.

Benefits provided under a qualified plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, any death benefits provided for a participant's beneficiaries must be incidental.[10] Under this incidental death benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the retirement benefits payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental death benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth).

The before-death distribution rules under present law for IRAs are similar to the before-death distribution rules provided for qualified plans and are applied separately to each IRA owned by an individual.

After-death distribution rules

The Act provides rules that apply in the case of an employee's death before the employee's entire interest has been distributed. The Act provides that, if distributions have commenced to the employee before death, then the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. If distributions have not commenced before the participant's death, the Act provides permissible periods over which the remaining interest may be paid to a designated beneficiary. Under the Act, the beneficiary could elect to accelerate payments of the remaining interest.

Under the Act, similar rules are provided for after-death distributions from or under an individual retirement account or annuity. In addition, the rules applicable to after-death distributions under an annuity contract apply to a custodial account that is treated as a tax-sheltered annuity contract (sec. 403(b)(7)). Other tax-sheltered annuity contracts are subject to the after-death distribution rules applicable to annuity contracts under the Act (sec. 72(s)).

Qualifying rollover distributions

Under the Act, distributions of less than the balance to the credit of an employee under a qualified plan or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least

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[10] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.

50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury.

Explanation of Provisions

Distributions prior to age 59½

Under the bill, the 10-percent additional income tax on distributions prior to age 59½ is applied to amounts received from or under a qualified plan by a 5-percent owner unless the participant dies or becomes disabled (within the meaning of sec. 72(m)(7)). However, the bill provides that the tax does not apply to amounts attributable to contributions paid or benefits accrued before January 1, 1985. In applying the rule, the bill provides that distributions will be deemed to be made first out of contributions made or benefits accrued before January 1, 1985.

The bill removes the requirement of present law that each plan distribution must be examined to determine whether it is attributable to contributions made on behalf of a participant while the participant was a 5-percent owner. Instead, the bill provides that the status of an individual at the time of a plan distribution is the relevant factor for imposition of the tax.

The bill defines a 5-percent owner as any individual who at any time during the 5 plan years preceding the plan year in which the distribution is made was a 5-percent owner (within the meaning of sec. 416(i)(1)(B)).

Before-death and after-death distribution rules

The bill clarifies the required beginning date for distributions from or under qualified plans, tax-sheltered annuities, and IRAs and extends to tax-sheltered annuities the distribution rules applicable to qualified plans. As noted above, under current law, in the case of a 5-percent owner, distributions from a qualified plan must commence no later than April 1 of the calendar year following the year in which the 5-percent owner attains age 70½. The bill clarifies that an individual is considered to be a 5-percent owner for a calendar year if the individual was a 5-percent owner (within the meaning of section 416(i)(1)(B)) at any time during the plan year ending in the calendar year in which the individual attains age 70½, or during any of the four preceding plan years. The bill also clarifies that if an employee becomes a 5-percent owner in a plan year subsequent to the plan year in which the employee attained age 70½, the required beginning date is April 1 of the calendar year following the calendar year in which ends the plan year that the employee becomes a 5-percent owner.

The bill clarifies that distributions from IRAs are to commence no later than April 1 of the calendar year following the year in which the owner of the IRA attains age 70½, without regard to whether the owner has retired. In addition, the bill clarifies that distributions from IRAs are subject to the incidental death benefit rules applicable to qualified plans.

Under the bill, the required beginning date and the general before-death and after-death distribution rules applicable to qualified plans also apply to amounts held under tax-sheltered annuity contracts (including custodial accounts held by regulated investment companies and to retirement income accounts provided by churches, etc.). The qualified plan distribution rules extended to tax-sheltered annuities by the bill would apply only to benefits accrued under the contract after the June 30 or December 31, next following the issuance of Treasury regulations under the qualified plan distribution rules. With respect to the majority of tax-sheltered annuities and accounts, which are structured as defined contribution plans, contributions and earnings thereon would be treated as benefit accruals for purposes of this rule. The bill also codifies the requirement that distributions from a tax-sheltered annuity satisfy the incidental death benefits rule. As a result of the amendments to section 403(b) made by the bill, if a tax-sheltered annuity fails to satisfy the distribution requirements (in form or in operation), then the amounts held under the contract are to be included in the employee's gross income (sec. 403(c)).

The bill repeals the exception to the required distribution rules applicable to amounts held by an ESOP, which are subject to the 84-month rule of Code Section 409(a). Instead, the bill provides an exception to the 84-month rule for amounts required to be distributed under the required distribution rules for qualified plans.

Further, the bill provides that amounts required to be distributed from a qualified plan, IRA, or tax-sheltered annuity under the required distribution rules are not eligible for rollover treatment. This rule ensures that an individual will not be able to circumvent the required distribution rules by taking a required distribution at year's end and rolling over that distribution after the beginning of the next year. This restriction would apply only to the amounts required to be distributed. Thus, individuals would not be prevented from rolling over those distributions that exceed the minimum required distribution. For this purpose, the first amounts distributed to an individual during a taxable year are treated as amounts required to be distributed.

Qualifying rollover distributions

The bill clarifies that the distribution of the entire balance to the credit of an employee in a qualified plan may be treated as a distribution eligible for rollover under the partial distribution rollover rules, so long as such distribution does not constitute a "qualified total distribution." Thus, a total distribution that is not made on account of plan termination, is not eligible for lump sum treatment and does not consist of accumulated deductible employee contributions, would be eligible for rollover under the partial distribution rollover rules.

The bill clarifies that accumulated deductible employee contributions (within the meaning of sec. 72(o)(5)) are not taken into account for purposes of calculating the balance to the credit of an employee under the partial distribution rollover rules. In addition, the bill clarifies that a self-employed individual is generally treated as an employee for purposes of the rules governing the tax treat-

ment of distributions, including the rules relating to rollover distributions.

The bill provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollovers to an IRA but not to another qualified plan. Also, the bill clarifies that partial distributions are to be rolled over within 60 days of the distribution to be eligible for rollover under the partial distribution rollover rules.

Further, the bill provides that a pension plan is not treated as failing to be a qualified plan merely because it makes distributions of the entire balance to the credit of employees on account of plan termination prior to the time the employees otherwise would be eligible for distributions.

b. Treatment of distributions if substantially all contributions are employee contributions (sec. 1552(c) of the bill and sec. 72 of the Code)

Present Law

Under the Act, if substantially all of the contributions under a qualified plan are employee contributions, then distributions under the plan will be considered to be income until all income has been distributed. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan, the Act treats the amount of the loan as an amount distributed from the plan.

The Act defines a plan in which substantially all of the contributions are employee contributions as a plan with respect to which 85 percent of the total contributions during a representative period (such as 5 years) as determined under Treasury regulations are employee contributions (whether or not mandatory).

Explanation of Provision

Under the bill, a plan is defined as one in which substantially all of the contributions are employee contributions if more than 85 percent of the total contributions during a representative period are employee contributions. Also, the bill provides that the 5-percent additional income tax on premature distributions from annuity contracts does not apply to distributions from a plan substantially all of the contributions of which are derived from employee contributions.

The bill clarifies that deductible employee contributions are not taken into account as employee contributions for purposes of testing whether more than 85 percent of total contributions to a plan during a representative period are employee contributions.

c. Provisions relating to top-heavy plans (sec. 1552(d) of the bill and sec. 416 of the Code)

Present Law

Additional qualification standards are provided with respect to a qualified plan that is top-heavy. These rules are designed to provide safeguards for rank-and-file employees and to curb abuse of

the special tax incentives available under qualified plans. These rules (1) limit the amount of a participant's compensation that may be taken into account; (2) require accelerated vesting; (3) provide minimum nonintegrated benefits or contributions for plan participants who are not key employees; and (4) reduce the overall limit on contributions and benefits for certain key employees.

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of cumulative accrued benefits under the plan is allocable to key employees. Under the Act, the cumulative accrued benefits of any individual who has not received any compensation from any employer maintaining a plan during a period of 5 plan years ending on the determination date may be disregarded for purposes of determining whether the plan is top heavy.

The Act provides that the additional standards for top-heavy plans do not apply to a governmental plan (as defined in sec. 414(d)), but does not clarify whether State or local government employees may be considered key employees for purposes of other nondiscrimination provisions (e.g., sec. 79).

Explanation of Provision

The bill amends the definition of a key employee to exclude any individual who is an officer or employee of an entity described in section 414(d) (relating to governmental plans). The effect of this provision is to clarify that certain separate accounting and nondiscrimination provisions of the Code (e.g., secs. 79, 415(l), and 419A) do not apply to employees of a State or local government or certain other governmental entities. The bill does not repeal the provision that exempts governmental plans from the top-heavy plan requirements.

The bill also provides that the rule disregarding benefits of an employee after 5 plan years applies to employees who have not performed services for the employer maintaining the plan at any time during the 5-year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

d. Provisions relating to estate and gift taxes with respect to qualified plan benefits (sec. 1552(e) of the bill and secs. 2039 and 2517 of the Code)

Present Law

Under present law, if the spouse of an employee on whose behalf contributions or payments are made to a qualified plan or a tax-sheltered annuity predeceases the spouse, the decedent spouse's estate does not include any community property interest in the employee spouse's interest in the employer-derived benefits under the qualified plan. A similar rule applies for purposes of the effect of certain transfers under the gift tax provisions.

In addition, present law provides that the exercise or nonexercise by an employee of an election or option under which an annuity

will become payable to a beneficiary under a qualified plan, a tax-sheltered annuity, an IRA, or certain military pensions is not considered a transfer for purposes of application of the gift tax provisions.

Explanation of Provision

Under the bill, the special community property rules applicable to qualified plans for purposes of the estate and gift tax provisions are repealed. However, the bill clarifies that, if a transfer is made to an employee spouse by a nonemployee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (secs. 2056 and 2523).

The bill also repeals the general exemption from the gift tax provisions of transfers pursuant to the exercise or nonexercise by an employee of an election or option under a qualified plan, etc.

Effective Date

The bill applies to gifts made or decedents dying after the date of enactment.

e. Affiliated service groups and employee leasing arrangements (sec. 1552(f) of the bill and sec. 414 of the Code)

Present Law

Under the Act, the Secretary of the Treasury is granted regulatory authority to develop rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing provisions apply through the use of employee leasing or other arrangements (sec. 414(o)).

Explanation of Provision

Under the bill, the special regulatory authority provided to the Secretary of the Treasury with respect to abuses through the use of affiliated service groups (sec. 414(m)(7)) is repealed in favor of the broader general authority provided under the Act (sec. 414(o)). In addition, the bill clarifies that the other definitions relating to affiliated service groups (sec. 414(m)(6)) continue to apply.

f. Discrimination standards applicable to cash or deferred arrangements (sec. 1552(g) of the bill and sec. 401(k) of the Code)

Present law

The Act requires that all elective deferrals made by a participant under all cash-or-deferred arrangements of an employer be aggregated for purposes of calculating that participant's actual deferral percentage. In addition, the Act provides that a cash-or-deferred arrangement is a qualified cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash-or-deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement

is treated as an employee contribution under the plan which, under the usual rules, could be wholly or partly nondeductible.

Explanation of Provision

Under the bill, if an employee participates in more than one cash-or-deferred arrangement of an employer, all such cash-or-deferred arrangements are treated as one arrangement for purposes of determining the employee's actual deferral percentage. Thus, an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer is the sum of the elective deferrals for that employee under each plan of the employer which provides a cash-or-deferred arrangement, divided by the participant's compensation from the employer.

In addition, the bill clarifies that a plan which includes an otherwise qualified cash-or-deferred arrangement that satisfies the special tests provided by section 401(k)(3) will be treated as satisfying the general nondiscrimination test of section 401(a)(4) with respect to the elective deferrals.

g. Treatment of certain medical, etc., benefits under section 415 (sec. 1552(h) of the bill and sec. 415 of the Code)

Present Law

Under the Act, any defined benefit pension plan that provides medical benefits to retired employees is required to create and maintain an individual medical benefit account for any participant who is a 5-percent owner (within the meaning of sec. 416(i)(1)(B)) and to treat contributions allocated to such accounts as annual additions for purposes of the overall limits on contributions and benefits. A similar rule, applicable to post-retirement medical benefits provided through a welfare benefit funds, requires separate accounting for all key employees.

Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee. The 25-percent limit prevents reserve additions for a retired employee who has no compensation.

Explanation of Provision

The bill clarifies that the special rules for post-retirement medical benefits apply to any pension or annuity plan under which such benefits are provided.

In addition, the bill changes the definition of employees for whom separate accounting is required under a pension plan to conform to the definition provided to the separate accounting for post-retirement medical and life insurance benefits under a welfare benefit fund. Thus, separate accounting is required with respect to any employee who is a key employee (within the meaning of section 416(i)).

Further, the bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions.

For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions, even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (sec. 415(e)).

4. Fringe Benefit Provisions (sec. 1553 of the bill, sec. 531 of the Tax Reform Act of 1984, and secs. 132, 125, and 4977 of the Code)

a. Clarification of line of business requirement

Present Law

Section 132(a)(2) excludes from income certain qualified employee discounts offered on property or services offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. For purposes of the discount exclusion, a leased section of a department store is treated as part of the line of business of the person operating the store and employees of the leased section are treated as employees of that person. A leased section of a department store is defined as any part of a department store where over-the-counter sales of property are made and certain other conditions are satisfied.

Explanation of Provision

The bill clarifies that a leased section of a department store which, in connection with the offering of beautician services, customarily makes sales of beauty aids in the ordinary course of business will be treated as engaged in over-the-counter sales of property, and thus will be treated as a part of the line of business of the person operating the store.

b. Definition of dependent children

Present Law

Section 531 of the Act provides exclusions from gross income for no-additional-cost services and certain other fringe benefits. These

exclusions generally apply to benefits provided by an employer for use by an employee, the employee's spouse, or the employee's dependent child. The 1984 Act defines the latter term to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased (Code sec. 132(f)(2)(B)).

Explanation of Provision

The bill defines dependent child to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased and who has not attained age 25.

c. Clarification of cross-reference

Present Law

Code section 132(f) provides that for purposes of paragraphs (1) and (2) of subsection (a), any use by the spouse or a dependent child of the employee is treated as use by the employee. The cross-references are to both the no-additional-cost service exclusion (sec. 132(a)(1)), which applies to a service provided by an employer to an employee for use by such employee if certain conditions are met, and also the qualified employee discount exclusion (sec. 132(a)(2)), which applies in certain circumstances where the price at which property or services are provided to the employee by the employer is less than the price to nonemployee customers.

Explanation of Provision

To clarify the mechanics of the cross-reference in Code section 132(f), the bill adds the words "for use by such employee" in section 132(a)(2). Accordingly, the qualified employee discount exclusion applies in certain circumstances where the price at which property or services are provided to the employee by the employer for use by such employee (or the spouse or dependent children of the employee) is less than the price to nonemployee customers.

d. Cross-reference in definition of customer

Present Law

Under Code section 132(i), the term customers does not include nonemployee customers except for purposes of section 132(c)(2)(B), relating to the determination of gross profit percentage as a limitation on the exclusion for qualified employee discounts.

Explanation of Provision

The bill provides that this exception to the definition of customers also applies for purposes of section 132(c)(2)(A), defining the term gross profit percentage.

e. Excise tax on certain fringe benefits

Present Law

Under the Act, the line of business limitation otherwise applicable to the section 132 exclusions for no-additional-cost services and

qualified employee discounts is relaxed under an elective grandfather rule set forth in section 4977. The requirements for that provision necessitate determining the employees in certain lines of business of the employer.

The provision is intended to clarify the application of the grandfather rule to the employee discount program of Agway, Inc.

Explanation of Provision

The bill provides that section 4977 is to apply only with respect to employment within the United States, except as otherwise provided in Treasury regulations.

f. Applicability of section 132(a)(1) exclusion to certain pre-divestiture retired telephone employees

Present Law

Section 531 of the 1984 Act excludes from income and wages the fair market value of a no-additional-cost service provided by an employer to an employee for use of the employee (Code sec. 132(a)(1)). This exclusion applies if (1) the employer incurs no substantial cost (including foregone revenue) in providing the service; (2) the service is provided by the employer (including certain businesses under common control) or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works; (3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and (4) for certain highly compensated employees, nondiscrimination requirements are met. Subject to certain transitional rules, the exclusion takes effect January 1, 1985.

Generally, situations in which an employer incurs no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity that otherwise would have remained unused because nonemployee customers would not have purchased it—e.g., where telephone companies provide telephone service to employees within existing capacity. Local telephone service and long-distance telephone service are considered the same line of business.

Explanation of Provision

The provision applies an intended transitional rule under which the fair market value of free telephone service provided to employees of the Bell System who had retired prior to divestiture of the system on January 1, 1984 is excluded from income and wages of such pre-divestiture retirement employees. The exclusion pursuant to the provision does not apply to the furnishing of any equipment or to the furnishing of any type of service that was not furnished to such retirees as of January 1, 1984.

The provision applies in the case of an employee who, prior to January 1, 1984, separated from service (by reason of retirement or disability) of an entity subject to the modified final judgment (as

defined in Code sec. 559(c)(4)). The provision does not apply to any employee who separated from such service on or after January 1, 1984. No inference is intended from adoption of this transitional rule as to the interpretation of the no-additional-cost service exclusion in any other circumstances.

Under the provision, all entities subject to the modified final judgment are treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service. Also, payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) is treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service.

For purposes of this provision, the term employee has the meaning given to such term in Code section 132(f). Except as otherwise provided in this provision, the general requirements for the Code section 132(a)(1) exclusion apply; e.g., the exclusion applies to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

g. Cafeteria plans

Present Law

Present law defines a cafeteria plan as a plan under which employees may choose (1) taxable benefits consisting of cash or certain other taxable benefits, or (2) certain fringe benefits that are specifically excluded from gross income by the Code (statutory fringe benefits).

Under the Act, the only taxable benefits which may be offered in a cafeteria plan consist of certain life insurance coverage that is not excludable from gross income, certain vacation pay, or cash. The life insurance coverage that may be offered is the coverage that is included in gross income to the extent the coverage exceeds $50,000 or to the extent it is provided on the life of a spouse or dependent of an employee. Vacation days may be provided under a cafeteria plan only if the plan precludes any participant from using (or receiving cash for) vacation days remaining unused as of the end of the plan year.

A cafeteria plan may offer any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code.

Under the Act, both general and special transition relief is provided with respect to the Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.

Explanation of Provision

Under the bill, the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes the reference in section 125 from nontaxable benefits to qualified benefits is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits, as permitted under Treasury regulations, can be provided in a cafeteria plan.

The bill makes two changes to the transition relief provided to certain cafeteria plans under section 531(b) of the Tax Reform Act of 1984. The first change provides that a cafeteria plan, in existence on February 10, 1984, maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second, the bill provides that a cafeteria plan which suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.

h. Working condition fringe

Present Law

Under the Act, the fair market value of any property or services provided to an employee of the employer is excludable for income and employment tax purposes as a working condition fringe only if and to the extent that payment for the property or servies by the employee would have been deductible by the employee as an ordinary and necessary business expense (under Code secs. 162 or 167) had the employee, rather then the employer, paid for such property or services.

Pursuant to this rule, the fair market value of the use of consumer goods that are manufactured for sale to nonemployee customers and that are provided to employees for product testing and evaluation outside the employer's premises is excluded as a working condition fringe only if (1) consumer testing and evaluation of the product is an ordinary and necessary business expense (other than as compensation) of the employer, (2) business reasons necessitate that the testing and evaluation be performed off-premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities), (3) the item is furnished to the employee for purposes of testing and evaluation, (4) the item is made available to the employee for no longer than necessary to test and evaluate its performance, and the item must be returned to the employer at completion of the testing and evaluation period, (5) the employer imposes limitations on the employee's use of the item that significantly reduce

the value of any personal benefit to the employee, and (6) the employee must submit detailed reports to the employer on the testing and evaluation. The fifth requirement above is satisfied, for example, if (i) the employer places limitations on the employee's ability to select among different models or varieties of the consumer product that is furnished for testing and evaluation purposes, (ii) the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of item as that being tested (so that personal use by the employee's family will be limited), and (iii) the employer requires that members of the employee's family generally cannot use the item. Gross income does not include the fair market value of personal use of such consumer goods provided to an employee primarily for such product testing and evaluation that does not qualify under the requirements above to the extent that the employee pays or reimburses the employer for the fair market value of such personal use.

Explanation of Provision

The committee clarifies the application of the product testing provision for purposes of the working condition fringe exclusion in the case of automobile testing. As described above, the product testing exclusion rule does not apply unless the employer imposes limitations on the employee's use of the item that significantly reduce the value of any personal benefit to the employee. The committee intends that this particular requirement is satisfied if the employer charges the employee a reasonable amount for any personal use of the automobile; thus, the product testing exclusion rule applies in such a case if all the other requirements for the rule are met.

An employer is treated as having imposed a sufficient charge for any personal benefits to an employee from the use of an evaluation product if the charge exceeds the cost to the employer in making the product available to employees.

The committee also clarifies the exception to the working condition fringe benefit rule for full-time automobile salesmen. This exception is not intended to be restricted to employees who have the formal job title of salesperson. Rather, the term is intended to apply to full-time employees of an automobile dealer who are automobile floor salespersons; to automobile salesmanagers; or to other employees who, as an integral part of their employment, regularly perform the functions of a floor salesperson or salesmanager, directly engage in the promotion and negotiation of sales to customers, and derive a significant part of their compensation from such activity. This provision, however, does not apply to owners of large automobile dealerships who do not customarily engage in significant sales activities.

i. Special rules for certain services related to air transportation

Present Law

Under the Act, the fair market value of any no-additional-cost service provided by an employer to an employee for the use of the employee, or for use of the employee's spouse or dependent children, is excluded for income and employment tax purposes.

Subject to a limited grandfather rule, the exclusion applies only if the no-additional-cost service provided to the employee is of the type that the employee offers for sale to nonemployee customers in the ordinary course of the line of business of the employer in which the employee is performing services.

Explanation of Provision

Under the bill, if, as of September 12, 1984, an individual was an employee of Pan Am World Services and was eligible for no-additional-cost services in the form of air transportation provided by Pan American Airways and such individual is providing services directly related to the transportation service of Pan Am World Services, then Pan Am World Services is treated as engaged in the same line of business as Pan American Airways for purposes of the no-additional-cost service exclusion.

In addition, if an individual performed services for a qualified air transportation organization and the services are performed primarily for persons engaged in providing air transportation and are of the kind that would qualify the individual for no-additional-cost services in the form of air transportation, then the qualified air transportation organization is treated as engaged in the line of business of air transportation with respect to that individual.

An organization is considered a qualified air transportation organization if (1) the organization was in existence on September 12, 1984, (2) the organization either (a) is described in section 501(c)(6) of the Code and membership of the organization is limited to entities engaged in the transportation by air of individuals or property for compensation or hire or (b) is a corporation all the stock of which is owned entirely by entities engaged in the transportation by air of individuals or property for compensation or hire, and (3) if the organization is operated in furtherance of the activities of its members or owners.

The committee also clarifies that employees of airline subsidiaries that engage in activities (such as providing food services on airline flights or providing ticketing and reservation services) normally engaged in directly by the air carrier are considered in the same line of buisness for purposes of the no-additional-cost service rule. These transition rules are intended to provide relief in the case of activities that had, at one time, been provided directly by an air carrier and which were spun off into a separate company. The committee does not intend the provision to apply to travel agencies or other organizations that have never been directly related to an air carrier.

j. Transitional rules for treatment of certain reductions in tuition

Present Law

The 1984 Act provides an exclusion for qualified tuition reductions provided to an employee of an educational institution for education below the graduate level. Also, the tuition reduction may be provided for the education of the spouse or a dependent child of the employee.

The Act provides that the tuition reduction exclusion is not available if the plan discriminates in favor of employees who are officers, owners, or highly compensated.

Explanation of Provision

Under the bill, for purposes of testing whether the tuition reduction program of Oberlin College is nondiscriminatory, a plan is treated as nondiscriminatory if it is nondiscriminatory taking into account certain special rules. First, with respect to all tuition reduction plans of Oberlin College, the plans are nondiscriminatory if the plans meet the nondiscrimination requirement when employees not included in the plan (who are included in a unit of employees covered by an agreement that the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that such benefits were the subject of good faith bargaining) are excluded from consideration.

A tuition reduction benefit provided by Oberlin College is treated as being provided under a separate plan if the level of the benefit was frozen before July 18, 1984. With respect to benefits for which the level of benefit is frozen, the plan is nondiscriminatory if the plan met the nondiscrimination requirements (taking into account the exclusion of union employees) on the day on which eligibility to participate in the plan closed and at all times thereafter, the tuition reductions available under the plan are available on substantially the same terms to all employees eligible to participate in the plan.

In addition, the bill provides that any tuition reduction provided with respect to a full-time course of education furnished at the graduate level before July 1, 1988, is not included in gross income if (1) the reduction would not have been included in income under Treasury Regulations in effect on July 18, 1984, and (2) the reduction is provided with respect to a student who was accepted for admission to such course of education before July 1, 1984, and began the course of education before June 30, 1985.

5. Employee Stock Ownership Plans (ESOPs)

a. Sales of stock to employee stock ownership plans or certain cooperatives (sec. 1554(a) of the bill and secs. 1042 and 4978 of the Code)

Present Law

In general

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative (EWOC) to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP or EWOC; (2) the ESOP or EWOC must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the ESOP or EWOC must

preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

Qualified securities; qualified replacement property

For purposes of this provision, the Act defines qualified securities as employer securities that (1) are issued by a domestic operating corporation that has no readily tradable securities outstanding, (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which includes both debt and equity instruments, as defined in sec. 165(g)(2)) consists of securities issued by another domestic corporation that does not, for the corporation's taxable year in which such securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year.

Disposition of qualified replacement property

In general, the Act provides that the basis of the taxpayer in qualified replacement property is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the employee organization which was not recognized pursuant to the election provided by this provision. The gain is to be recognized upon disposition of the qualified replacement property. However, the Act did not clarify the impact of any other rules that otherwise might permit nonrecognition treatment upon a direct or indirect disposition of the qualified replacement property.

Explanation of Provisions

Qualified securities; qualified replacement property

The bill makes several clarifying changes to the definition of qualified securities and qualified replacement property.

With respect to qualified securities, the bill makes it clear that stock of a corporation with no readily tradable stock outstanding may be eligible for nonrecognition treatment whether or not the corporation or any member of the controlled group has outstanding any readily tradable debt securities. The bill also clarifies that the nonrecognition provision applies only if the gain on the sale would otherwise have been long-term capital gain. For example, the sale of securities that had been held for less than six months, and the sale of securities which otherwise would be treated as ordinary income (e.g., by reason of the collapsible corporation provisions), will be ineligible for nonrecognition treatment under this provision.

With respect to qualified replacement property, the bill makes it clear that any debt or stock instrument that is a security within the meaning of section 165(g)(2) (other than securities issued by a government or political subdivision thereof) may be treated as replacement property if it meets the standards of the Code.

Qualified replacement property is limited under the bill to securities issued by a domestic operating corporation other than the corporation that issued the securities involved in the nonrecognition transaction. The bill generally defines a domestic operating corporation as a corporation substantially all the assets of which were, at the time the securities were purchased, used in the active conduct of a trade or business. However, if (1) the corporation issuing the qualified replacement property owns stock representing control of one or more other corporations, or (2) one or more other corporations own stock representing control of the corporation issuing the qualified replacement property, then all such corporations will be treated as one corporation for purposes of determining whether the corporation is a domestic operating corporation. For purposes of this provision, control means control within the meaning of section 304(c).

Further, the bill provides on extended replacement period for sellers who had acquired replacement property that, pursuant to this bill, will no longer be considered qualified replacement property. Under the bill, if a security was acquired by a taxpayer prior to September 27, 1985, and such security no longer constitutes qualifying replacement property, the period of time for the purchase of qualified replacement property is extended to the date one year from the date of committee action on the bill. Of course, this extension does not increase the amount of gain for which nonrecognition treatment may be claimed.

Thirty-percent test

Under the bill, the employee organization must own, immediately after the sale, at least 30 percent of the total value of all stock (other than preferred stock described in section 1504(a)(4)) of the corporation that issued the qualified securities. With respect to sales after September 27, 1985, in taxable years ending after that date, 30-percent ownership by the employee organization would be tested after application of the ownership attribution rules of Code section 318.

Exclusive benefit

The bill makes several clarifying changes to the requirement that the employee organization be maintained for the exclusive benefit of employees. First, the bill clarifies that no portion of the assets attributable to qualified securities with respect to which a nonrecognition election is made may be allocated to (1) a taxpayer seeking nonrecognition treatment, (2) any person who is related to that taxpayer in one of the ways described in Code section 267(b), or (3) any other person who owns (after application of the attribution rules of Code section 318(a)) more than 25 percent of the value of (a) any class of stock of the corporation that issued such qualified securities, or (b) any class of the stock of certain related corporations.

In addition, the bill makes it clear that this restriction applies to prohibit any direct or indirect accrual of benefits or an allocation of assets attributable to the qualified securities involved in the nonrecognition transaction. Thus, for example, an ESOP in which the taxpayer seeking nonrecognition treatment participates could not

allocate any assets attributable to the securities involved in the nonrecognition transaction to his account. Nor could the employer make an allocation of other assets to the taxpayer under the ESOP without making additional allocations to other participants sufficient separately to satisfy the nondiscrimination requirements of Code section 401(a).

Eligible taxpayers

Generally, effective for sales after March 28, 1985, the bill limits the class of taxpayers eligible to elect nonrecognition treatment under this provision by making the election unavailable to any subchapter C corporation. However, a subchapter C corporation may elect nonrecognition treatment with respect to certain sales made no later than July 1, 1985, provided the sales otherwise satisfy the requirements of this provision and are made pursuant to a binding contract in effect on March 28, 1985, and all times thereafter.

Disposition of qualified replacement property

The bill also clarifies the coordination of the provision's requirement that gain be recognized upon disposition of any qualified replacement property with other rules providing nonrecognition treatment. Effective for dispositions made after the date of enactment, the bill overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time. For this purpose, it is not intended that death be treated as a disposition. The amount of gain required to be recognized under this rule is limited to the amount not recognized pursuant to the election provided by this provision by reason of the acquisition of such replacement property. Any gain in excess of that amount continues to be eligible for any otherwise applicable nonrecognition treatment.

To ensure that this rule is not avoided through the use of controlled corporations, the bill provides special rules for corporations controlled by the taxpayer seeking nonrecognition property. If the taxpayer owns stock representing control (within the meaning of section 304(c)) of the corporation issuing the qualified replacement property, the taxpayer shall be treated as having disposed of such qualified replacement property when the corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.

b. Deduction for dividends paid on ESOP stock (sec. 1554(b) of the bill and sec. 404(k) of the Code)

Present Law

The Act permits an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP), but only to the extent such dividends are actually paid out currently to participants or beneficiaries. The employer may claim a deduction for dividends for the employer's taxable year when paid to the extent that the dividends (1) are, in accordance with the plan provisions, paid in cash directly to the participants, or (2) are paid to the plan and subsequently distributed to

the participants in cash no later than 90 days after the close of the plan year in which paid.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Accordingly, such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116. However, the Act does not clarify whether the treatment of such dividend distributions permits the recipient to reduce the amount includible in income by recovering, tax-free, any net employee contributions under the plan.

Explanation of Provision

The bill makes it clear that dividends paid on any employer stock held by the ESOP and actually allocated to a participant's account may be deducted under this provision, including those dividends paid on employer stock that is not considered to be qualified employer securities within the meaning of section 409(l). No deduction is permitted, however, with respect to employer stock held in a suspense account under an ESOP. The bill also makes it clear that current distributions of dividends paid on employer stock allocated to a participant's account under an ESOP will not be considered disqualifying distributions.

The bill clarifies that a corporation will be allowed a deduction for dividends paid on stock held by an ESOP whether such dividends are passed through to beneficiaries of plan participants or to the plan participants themselves. In addition, effective for dividends paid after the date of the bill's enactment, the bill makes it clear that employer deductions for dividends paid on employer stock held by an ESOP are to be permitted only in the year in which the dividend is paid or distributed to the participant beneficiary. Thus, where the employer pays such dividends directly to participants in accordance with plan provisions, a deduction would be permitted in the year paid. However, where the employer pays such dividends to the ESOP for redistribution to participants no later than 90 days after the close of the plan year, a deduction would be permitted in the employer's taxable year in which the dividend is distributed from the ESOP to the participants.

Moreover, also effective for dividends paid after the date of enactment, the bill makes it clear that, although the dividends for which the Act allows a deduction are generally to be treated as distributions under the plan, they are to be fully taxable. Thus, these distributions are not to be treated as distributions of net employee contributions.

Further, the bill empowers the Treasury to disallow deductions for dividends paid on stock held by an ESOP, if the dividend constitutes, in substance, the payment of unreasonable compensation.

c. Partial exclusion of interest earned on ESOP loans (sec. 1554(c) of the bill and sec. 133 of the Code)

Present Law

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan.

A securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(l)) for the plan.

Explanation of Provision

The bill clarifies the interaction of the partial interest exclusion with other provisions affecting tax-exempt income. First, the bill makes it clear that for purposes of section 291(e), relating to certain tax preference items (1) interest on an obligation eligible for the partial exclusion of section 133 will not be treated as exempt from tax, and (2) in determining the interest allocable to indebtedness on tax-exempt obligations, obligations eligible for the partial exclusion will not be taken into account in calculating the taxpayer's average adjusted basis for all assets.

In addition, the bill clarifies the coordination of the partial exclusion with the installment payment provisions (sec. 483) and the original issue discount rules (secs. 1271 through 1275). The bill makes it clear that, in testing the adequacy of the stated interest rate for purposes of applying the below-market interest rate rules, the applicable Federal rate will be adjusted as appropriate to reflect the partial interest exclusion.

d. Payment of estate tax liability by ESOP (sec. 1554(d) of the bill and sec. 2210 of the Code)

Present Law

If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor of the decedent's estate generally is relieved of the estate tax liability to the extent the ESOP or cooperative is required to pay the liability.

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative also may elect to pay any estate taxes attributable to the qualified employer securities trans-

ferred to the ESOP or cooperative in installments pursuant to that section. The Act provides that the usual rules (sec. 6166) apply to determine ongoing eligibility for deferral. Thus, for example, disposition of the qualifying securities held by the estate and employee organization may trigger acceleration of any remaining unpaid tax.

Explanation of Provision

The bill makes several changes to clarify the applicability of these provisions and the coordination with the provisions governing the installment payment of estate taxes under section 6166. First, the bill makes it clear, that, with respect to the estates of individuals dying after September 27, 1985, only executors of those estates eligible to make deferred payments of estate taxes may be relieved of estate tax liability under this provision. In addition, under the bill, the transfer of employer securities to an ESOP or to an eligible worker-owned cooperative will not be treated as a disposition or withdrawal which triggers acceleration of the remaining unpaid tax.

The bill makes it clear that, after the transfer, the ongoing eligibility of the estate and the ESOP or cooperative to make installment payments applicable to their respective interests is to be tested separately. Thus, with respect to the estate's remaining interest (if any), cumulative dispositions and withdrawals of amounts up to 50 percent of the estate's remaining interest would be permitted without requiring acceleration of the remaining unpaid tax. Similarly, with respect to an ESOP or cooperative, cumulative dispositions and withdrawals of up to 50 percent of the interest transferred to such organization would be permitted without requiring acceleration. In addition, under the bill, a distribution made by an ESOP to participants on account of death, retirement after attainment of age 59-1/2, disability, or any separation from service resulting in a one-year break in service will not be treated as a disposition requiring acceleration of any unpaid tax and will not be taken into account in determining whether any subsequent disposition triggers acceleration.

The bill also makes it clear that no executor will be relieved of estate tax liability with respect to employer securities transferred to an eligible worker-owned cooperative unless the cooperative guarantees the payment of any estate tax or interest by surety bond or other means as required by the Secretary of the Treasury.

6. Miscellaneous Provisions

a. Incentive stock option provision (sec. 1555 of the bill and secs. 57 and 422A of the Code)

Present Law

The Act clarifies that the fair market value of stock, for purposes of applying the incentive stock options provisions, is determined without regard to lapse restrictions.

The Act applies, for purposes of the minimum tax, to options exercised after March 20, 1984. Transitional relief was provided for certain options exercised on or before December 31, 1984.

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Explanation of Provision

The bill clarifies that, under the transitional rule, the amendment to the minimum tax provision relating to incentive stock options (sec. 57(a)(10)) will not apply to options exercised before January 1, 1985, if the option was granted pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

b. Time for making certain section 83(b) elections (secs. 1555(b) of the bill and sec. 556 of the Act)

Present Law

The Act extended the time for making certain section 83(b) elections where property was transferred to the taxpayer after June 30, 1976 and before November 18, 1982, where the taxpayer paid fair market value (determined without regard to certain restrictions).

Explanation of Provision

The bill extends the provision of that 1984 Act to transfers made before July 1, 1976.

F. Technical Corrections to the Tax-Exempt Bond Provisions

1. Mortgage subsidy bond and mortgage credit certificate provisions (secs. 1561-1563 of the bill and secs. 25 and 103A of the Code)

Present Law

Mortgage subsidy bonds

The Act extends the tax-exemption for qualified mortgage bonds for four years, for bonds issued after December 31, 1983, and before January 1, 1988. These bonds generally are subject to the same restrictions as applied to such bonds issued before January 1, 1984.

The Act restricts the issuance of qualified veterans' mortgage bonds by (1) limiting the veterans eligible for loans financed with these bonds, and (2) imposing State volume limitations based on pre-1984 issuance of the bonds. The Act further directs the Federal Financing Bank to make cash flow loans to the Oregon Department of Veterans' Affairs to offset lower than anticipated prepayments on loans funded with specified veterans' mortgage bonds.

Mortgage credit certificates

As an alternative to qualified mortgage bonds, the Act permits States to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds.

Explanation of Provisions

Mortgage subsidy bonds

The bill clarifies that, in certain cases, the Treasury Department may grant extensions of time for publishing annual policy statements that issuers of qualified mortgage bonds are required to make. These statements must explain measures taken by the issuers to comply with the Congressional objective of providing housing for lower-income persons.

The bill further clarifies that the requirement of this annual policy statement and the requirements that (1) certain information be reported to Treasury with respect to each bond issue and (2) a State official certify compliance with Code restrictions are treated as satisfied if the issuer in good faith attempted to meet the requirement and the failure to meet the requirement is due to inadvertent error.

The bill clarifies that veterans eligible for loans financed by qualified veterans' mortgage bonds must apply for the financing before the later of (1) 30 years after leaving active service, or (2) January 31, 1985 (rather than January 1, 1985).

The bill provides that the Oregon Department of Veterans' Affairs (Oregon) may advance refund up to $300 million of qualified veterans' mortgage bonds. (Advance refundings of mortgage subsidy bonds generally are prohibited.) The advance refunding is in lieu of authority included in the Act permitting that State agency to receive cash flow loans not exceeding $300 million at any time from the Federal Financing Bank (FFB). This provision is effective on the date of enactment, and does not affect the status of cash flow loans made under an interim financing agreement entered into between Oregon and the FFB before that date. Finally, the bill permits Oregon to elect to carryforward veterans' mortgage bond volume authority from 1985 for these bonds in lieu of allocating bond authority from the unified volume limitation (described in Title VII of the bill) if a carryforward election is made before January 1, 1986, using rules similar to those for electing under present law to carryforward private activity bond volume limitation.

Mortgage credit certificates

Issuers of qualified mortgage bonds must satisfy information reporting requirements, must certify that the bonds meet the volume limitation requirement of the Code, and must publish annual policy statements demonstrating that their programs satisfy Congress' objective in authorizing issuance of tax-exempt bonds for this purpose. The bill clarifies that these requirements also apply with respect to MCCs.

The bill clarifies that good faith errors in MCC program administration may be corrected without invalidating all MCCs issued under the program. The bill further clarifies the method for determining the amount of excess credit that may be carried forward for up to three years by a taxpayer.

Miscellaneous

The bill makes other minor clerical and technical corrections.

2. Private activity bond provisions (secs. 1564-1574 of the bill and sec. 103 of the Code)

Present Law

Volume limitations

Private activity bonds generally are subject to State volume limitations. The limitations apply to most industrial development bonds (IDBs) and to student loan bonds issued within the State. Certain bonds issued to finance governmentally owned airports, docks, wharves, convention or trade show facilities, and mass commuting facilities are not subject to these volume limitations.

The Act provides a statutory formula for allocating each State's volume limitation among issuers within the State. This Federal formula may be overridden by State statute, or by gubernatorial proclamation on an interim basis. Issuers may elect to carry forward bond authority for up to three years (six years in certain cases) for certain, specifically identified projects.

Prohibition on Federal guarantees of tax-exempt bonds

The Act provides that interest on bonds, repayment of which is directly or indirectly guaranteed (in whole or in part) by the Federal Government, is taxable. The underlying economic substance of a transaction determines whether repayment of bonds is Federally guaranteed. Thus, depending on the facts and circumstances of each case, a Federal guarantee may arise from contracts providing for purchase of the output of a facility by the Federal Government, from leases of property to the Federal Government, and from other similar arrangements, as well as from a direct agreement to repay the bonds.

Additional arbitrage restrictions for most IDBs and for student loan bonds

In the case of IDBs (other than IDBs for multifamily residential rental property), the Act limits the amount of bond proceeds that may be invested in obligations not related to the purpose of the borrowing and requires rebates to the Federal Government of arbitrage profits in certain cases. The Act also directs the Treasury Department to prescribe regulations extending additional arbitrage restrictions similar to those for most IDBs to student loan bonds.

$40 million limit on small-issue IDBs

The Act prohibits tax-exemption for small-issue IDBs if a beneficiary of the IDBs is a beneficiary of more than $40 million of all types of tax-exempt bonds. Bonds used to redeem other bonds do not count towards the $40 million limit; however, such refunding bonds may not be issued if a beneficiary of the bonds benefits from more than $40 million of outstanding bonds at the time of the refunding.

Consumer loan bonds

The Act provides that interest on bonds generally is not tax-exempt if five percent or more of the proceeds is reasonably expected to be used, directly or indirectly, to make loans to nonexempt persons. Exceptions are provided for IDBs, qualified student loan bonds, mortgage subsidy bonds, and for certain bonds used to finance assessments or taxes of general application for an essential governmental function.

As enacted in 1984, this restriction makes no distinction between bonds that are used to finance loans for businesses and bonds used to finance personal loans. For example, an issue may be in violation of this restriction if 5 percent or more, but no more than 25 percent, of the proceeds is used to provide financing that would be considered IDB-financing, but for the fact that bonds are not treated as IDBs if no more than 25 percent of the proceeds is used for a purpose described in section 103(b). Similarly, an obligation that would be an IDB except for the fact that the security interest test of section 103(b)(2)(B) is not satisfied may be in violation of this restriction.

Restriction on acquisition of existing facilities

The Act restricts tax-exempt financing for the acquisition of existing facilities to cases where an amount equal to at least 15 percent of the bonds is spent on rehabilitation of a building and associated equipment. In the case of structures other than buildings, the rehabilitation expenditures must equal or exceed the amount of bond financing.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The Act provides that bonds issued pursuant to provisions of law other than the Internal Revenue Code must satisfy appropriate Code requirements as a condition of tax-exemption. Examples of these requirements are the Code restrictions on IDBs, the arbitrage rules, the prohibition on Federal guarantees of tax-exempt bonds, the State volume limitations, and the public approval and information reporting requirements.

Small-issue IDB principal user rule

Small-issue IDBs generally may not exceed $1 million per issue. If a special election is made, this limit is increased to $10 million, but all capital expenditures that principal users of the facility incur within a prescribed period with respect to facilities located in the same municipality (or county, if not in any municipality) are aggregated with the amount of the bonds in determining whether the $10 million limit is exceeded.

Effective dates

Section 631 of the Act provides effective dates for the various tax-exempt bond provisions for which (1) no separately stated effective dates are included as part of the section of the Act containing the substantive rule, or (2) no effective dates are provided by means of dates included within substantive rules identifying the bonds to which the rules apply. Transitional exceptions are provided with respect to many of the provisions for which the effective dates are provided in Act section 631. Additionally, special exceptions are provided in Act sections 631 and 632 for certain specifically described facilities.

Explanation of Provisions

Volume limitations

Facilities located outside a State.—The bill clarifies that each State's annual private activity bond volume limitation generally may be used only to finance facilities located within that State. Under this clarification, a State may allocate a portion of its volume limitation to financing for facilities located outside its boundaries only in the case of specified facilities, and only to the extent of the State's share of the use of those facilities.

Facilities located outside a State and to which a State may allocate a portion of its volume limitation include (1) otherwise eligible sewage and solid waste disposal facilities or facilities for the local furnishing of electric energy or gas (sec. 103(b)(4)(E)); (2) otherwise

eligible facilities for furnishing of water (sec. 103(b)(4)(G)); and (3) qualified hydroelectric generating facilities (sec. 103(b)(4)(H)). This clarification does not affect the rule in Code section 103(o)(3) that qualified student loan bonds must be issued to finance loans both to (1) residents of the State issuing the bonds regardless of the location of the school the residents attend, and (2) students attending schools within the issuing jurisdiction, regardless of the State of their legal residence, since no facilities are financed with student loan bonds.

In the case of sewage and solid waste disposal facilities, the determination of a State's use of a facility is based on the percentage of the facility's total treatment provided to the State (and its residents). In the case of facilities for the local furnishing of electric energy and gas, facilities for the furnishing of water, and qualified hydroelectric generating facilities, the determination of use is based upon the share of the output of the facility received by the State (and its residents).

These clarifications generally are effective for bonds issued after the date of the bill's enactment. Under a special rule, a State may elect to apply this rule in the case of bonds issued before the date of enactment.

Certain facilities financed outside a State's volume limitation.—The bill clarifies that the determination of whether facilities forming a part of an airport, dock, wharf, mass commuting facility, or trade or convention center may be financed outside a State's volume limitation is to be made on a property-by-property basis rather than by reference to the entire airport or other excepted facility. Under the bill, *all* property to be financed pursuant to this exception must be owned by or on behalf of a governmental unit. Therefore, property financed with the so-called "insubstantial portion" of bond proceeds that otherwise could be used for a purpose other than the governmental purpose for which the bonds are issued also must be governmentally owned.

Designation of carryforward projects.—The committee wishes to clarify statements included in the legislative history accompanying the Act concerning the designation of projects for which an election is made to carryforward annual private activity bond volume authority. That legislative history, in explaining the authority of the Treasury Department to require specific identification of all projects for which an issuer makes a carryforward election, included a specific street address as information Treasury might require in the notice of election. (Temporary Treasury regulations on that provision require a specific address for all elections with respect to exempt-activity IDBs.)

The committee believes that, in the case of solid waste disposal facilities (described in sec. 103(b)(4)(E)) that will process solid waste from all residents of the issuing governmental unit, Treasury should be authorized to waive the requirement of a specific street address if the location of the facility otherwise is established with reasonable certainty. On the other hand, in the case of facilities such as air or water pollution control facilities, and other facilities financed with exempt-activity IDBs that are identified more specifically with a limited group of users or more than one of which may be financed within the jurisdiction of the issuing governmental

unit, a specific street address appropriately is required when the carryforward election is made.

Authority to allocate a State's volume limitation directly to issuing authorities other than governmental units.—The bill clarifies that a State may allocate its private activity bond volume limitation directly to issuing authorities within the State that are not governmental units as well as to such governmental units. This clarification applies to allocations pursuant to gubernatorial proclamations and also to allocations pursuant to State statutes.

Reporting requirement for allocations of volume limitations.—The bill clarifies the authority of the Treasury Department to require reports on allocations of State volume limitations as part of the presently required information reporting (Code sec. 103(*l*)).

Prohibition on Federal guarantees

The bill provides transitional relief for a convention center (Carbondale, Illinois) to be financed with bonds for which the Farmers' Home Administration had authorized a Federal guarantee before enactment of the Act.

The bill also provides transitional exceptions for a limited amount of bonds for four solid waste disposal facilities. Bonds for these facilities are indirectly Federally guaranteed as a result of the anticipated purchase by the Federal Government under contract of more than an insignificant portion of the output of the facilities. These facilities are located in Aberdeen and Annapolis, Maryland, in Norfolk, Virginia, and in Charleston, South Carolina. Expenditures were made with respect to each facility before October 19, 1983.

Additionally, the bill expands a transitional exception from other provisions of the Act to include the restriction on Federal guarantees in the case of bonds for a solid waste disposal facility (Huntsville, Alabama) where 5 percent or more of the bond proceeds are indirectly guaranteed by the Federal government by reason of an agreement between that city government and the Department of the Army regarding construction and operation of the facility.

Additional arbitrage restrictions for most IDBs and student loan bonds

The bill corrects a reference to a resource recovery project of Essex County, New Jersey, contained in a transition rule to the additional arbitrage restrictions for most IDBs. Additionally, the bill clarifies the application of an exception for refundings of student loan bonds in the case of a series of refundings.

$40 million limit on small-issue IDBs

The bill permits small-issue IDBs to be refunded to reduce the interest rate on the borrowing even though a beneficiary of the bonds benefits from more than $40 million in tax-exempt financing. Small-issue IDBs may be refunded in such cases only if (1) the maturity of the refunded bonds is not extended; (2) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds; (3) the interest rate on the refunding bonds is lower than the rate on the refunded bonds; and (4) the refunded bonds are redeemed no later than 30 days after issuance of the refunding

bonds (i.e., called so that no interest accrues on the refunded bonds after such time).

Consumer loan bonds

The bill retitles consumer loan bonds "private loan bonds" to reflect the fact that, under that provision of the Act, all bonds issued to finance loans to nonexempt persons are subject to this restriction unless a specific exception is provided in the Code (e.g., the exceptions for IDBs, mortgage subsidy bonds, qualified student loan bonds, and certain bonds to finance assessments or taxes of general application for an essential governmental function). This provision does not amend the substantive scope of the restriction, as enacted in 1984.

The bill also corrects a reference to the amount of nonqualified student loan bonds that may be issued by a specified State agency (Illinois) under a transition rule to the private loan bond restriction. Additional transitional exceptions are provided for bonds for certain specified facilities with respect to which indirect loans to nonexempt persons will be made through contracts providing the persons with a significant portion of the output of the facilities. The facilities to which these exceptions relate are (1) bonds issued before 1985 for the White Pine, Nevada power project; (2) bonds for the St. Johns River Power Park, Florida, issued before September 26, 1985, and subject to additional restrictions, current refunding bonds and additional financing issued after that date; (3) bonds for the Mead-Phoenix power project for which other transitional relief was provided in the Act; and (4) up to $27 million of bonds for the City of Baltimore, Maryland, to finance advances made by that City on or before October 19, 1983, pursuant to a voter referendum held before November 3, 1982.

Restriction on acquisition of existing property

The bill provides an exception from the Act's restriction on the acquisition of existing property for up to $200 million of bonds issued for the acquisition of existing pollution control facilities by the Gulf Coast Waste Disposal Authority that the Authority itself will operate. Issuance of these bonds is subject to the following additional conditions: (1) the bonds are subject to the applicable State volume limitation for private activity bonds and all other restrictions currently applicable to similar IDBs (other than the restriction on acquisition of existing property); (2) the purchase price of the facilities may not exceed their fair market value; (3) the fees imposed on any seller for use of any facilities after the sale may not be less than the amounts charged for use of such facilities by persons other than the seller; and (4) no person other than the Authority may be considered the owner of the facilities for Federal income tax purposes.

In addition, only those facilities the acquisition of which was contemplated when tax-exempt financing for this purpose originally was authorized qualify for tax-exempt financing. Therefore, bonds issued under this provision may be used only for acquisition of facilities the original use of which commenced before September 3, 1982. The committee understands that the only qualifying facilities are the following:

Armco Steel
13609 Industrial Road
Houston, Texas

Diamond Shamrock
Tidal Road
Deer Park, Texas 77536

Dow Chemical Company
Battleground Road
La Porte, Texas 77571

E. I. du Pont
11701 Strang Road
La Port, Texas 77571

Ethyl
1000 North South Street
Pasadena, Texas 77503

Exxon
2800 Decker Drive
Baytown, Texas 77520

GAF
Hwy. 146 at Industrial Rd.
Texas City, Texas 77590

Goodyear
2000 Goodyear Drive
Houston, Texas 77017

Lubrizol Corp.
41 Tidal Road
Deer Park, Texas 77536

Lyondell Petrochemical Co.
12000 Lawndale
Houston, Texas 77252-2451

Marathon Petroleum Corp.
Foot of Sixth Street
Texas City, Texas 77590

Pasadena Chemicals
Hwy. 225
Pasadena, Texas

Phillips Chemical Co.
1400 Jefferson Street
Pasadena, Texas 77501

Rohm and Haas
Private Road off Hwy. 225
Deer Park, Texas 77536

Shell Oil
Shell Chemical
Hwy. 225 at Center Street
Deer Park, Texas 77536

Stauffer Chemical
1000 Jefferson
Houston, Texas

St. Regis Paper
11611 Fifth Street
Sheldon, Texas 77044

Texas Alkyls
730 Battleground Road
Deer Park, Texas 77536

Texas City Refining
Loop 197 South at 14th St.
Texas City, Texas 77017

Texas Petrochemicals
8600 Parkplace Blvd.
Houston, Texas 77017

U.S. Industrial Chemicals
1515 Miller Cutoff Road
Deer Park, Texas 77536

USS Chemicals
9822 La Porte Freeway
Houston, Texas 77017

U.S. Steel
FM 1405
Baytown, Texas 77520

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The bill clarifies that bonds issued pursuant to provisions of law other than the Code (non-Code bonds) must be issued in registered form. Additionally, the bill clarifies that the private (consumer) loan bond restriction applies to non-Code bonds. These clarifications are effective for bonds issued after March 28, 1985.

The bill also provides a limited exception permitting advance refundings of certain non-Code bonds issued before enactment of the

Act. (Under the Act, unless a specific exception is provided, bonds may not be refunded (either by a current or an advance refunding) unless the refunded bonds would be in compliance with appropriate Code requirements, if issued under the law as amended by the Act.) Under this exception, certain bonds issued under section 11b of the Housing Act of 1937 before December 31, 1983, may be advance refunded if (1) the bonds had a maturity date of 40 years or more when originally issued; (2) the maturity date of the refunding bonds does not exceed the maturity date of the refunded obligations; (3) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds; (4) the interest rate on the refunding bonds is lower than the rate on the refunded bonds; (5) all refunded bonds are redeemed no later than the first date on which the bonds may be redeemed without a call premium; and (6) the refunding bonds comply with all provisions applicable to Code bonds for multifamily residential rental projects, as of the date the refunding bonds are issued (other than the present-law prohibition on advance refunding such bonds and the unified volume limitation (described in Title VII)).

Exception for small-issue IDB principal user rule

The bill provides an exception from the small-issue IDB size limitations for specified amounts of bonds for two hydroelectric generating facilities (Hastings, Minnesota and Placerville, California) and a methane recovery electric generating facility (Contra Cosa County, California) output from which will be sold to a nongovernmental person pursuant to agreements in accordance with the Public Utilities Regulatory Policies Act of 1978 (PURPA). But for the amendment, the purchasers of power under these PURPA agreements would be treated as principal users of the facilities.

Effective dates

The bill clarifies the private activity bond provisions to which the effective dates provided in Act section 631(c) apply. These provisions are (1) the prohibition on Federal guarantees (Act sec. 622); (2) the aggregate limit for small issue bonds (Act sec. 623); (3) the restrictions on financing land, existing facilities, and certain specified facilities (Act sec. 627); (4) the rules relating to aggregation of certain related facilities, the definition of substantial user, and mixed use residential rental property (Act secs. 628(c), (d), and (e)); (5) the option for student loan bond authorities to issue taxable bonds (Act sec. 625(c)); (6) the public approval requirements for certain airports (Act sec. 628(f)); and (7) the authorization of tax-exempt financing for acquisition of a bankrupt railroad (Act sec. 629(b)).

The bill clarifies that the transitional exceptions contained in Act section 631(c)(3) apply only in the case of certain of the provisions enumerated in section 631(c)(1), as amended.

The bill further clarifies that the exception for obligations to finance facilities the construction, reconstruction, or rehabilitation of which was begun before October 19, 1983, applies only if the construction, reconstruction, or rehabilitation was completed on or after that date. Similarly, the exception for obligations issued to finance facilities with respect to which a binding contract to incur

significant expenditures for construction, reconstruction, rehabilitation, or acquisition was entered into before October 19, 1983, applies only if some of the expenditures are incurred on or after that date. For purposes of the binding contract rule, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the agreement is delivered rather than on the due date of each installment.

The two clarifications to these transitional exceptions requiring activity (e.g. construction) or expenditures after October 18, 1983, apply to obligations issued after March 28, 1985; however, no inference is intended that the same rules, do not apply to obligations issued on or before that date.

The bill clarifies that, subject to transitional exceptions, the prohibition on tax-exempt financing for health clubs applies to obligations issued after April 12, 1984 (rather than December 31, 1983).

Further, the bill provides that the private loan bond restriction of the Act does not apply to tax-increment financing bonds issued before January 1, 1986. Tax-increment financing bonds eligible for this exception are bonds substantially all of the proceeds of which are to be used to finance—

(1) sewer, street lighting, or other governmental improvements to real property,

(2) the acquisition of any interest in real property pursuant to the exercise of eminent domain (or the threat thereof), the preparation of such property for new use, or the transfer of such interest to a private developer, or

(3) payments of reasonable relocation costs of prior users of such real property.

All of these activities must be carried out pursuant to a redevelopment plan adopted before the bonds are issued by the governing body of the general governmental unit in which the real property being redeveloped is located. Repayment of the bonds must be secured by pledges of that portion of any increase in real property tax revenues (or their equivalent) attributable to the redevelopment resulting from the issue. (The fact that a governmental unit may pledge its full faith and credit in addition to incremental property tax revenues does not violate this requirement.) Also, no facilities located (or to be located) on land acquired with tax-increment financing bond proceeds may be subject to a real property or other tax based on a rate or valuation method which differs from the rate and valuation method applicable to any other similar property located in the general governmental unit in which the real property being redeveloped is located. (The fact that property located in different tax assessment districts is subject to different assessments does not violate this restriction as long as no special assessments are levied with regard to the redevelopment activities.)

Miscellaneous

The bill makes other minor clerical and technical corrections.

G. Technical Corrections to Miscellaneous Tax Provisions

1. Miscellaneous corporate provision (sec. 1575(b) of the bill and sec. 304 of the Code)

Present Law

Under present law, if a shareholder of a 50-percent owned corporation transfers stock of that corporation to another 50-percent owned corporation in exchange for property, the transaction is treated as a redemption of the shareholders' stock in the acquiring corporation. The transferred stock is considered to have been transferred by the shareholders as a contribution to capital of the acquiring corporation, and its basis is equal to the transferor's basis increased by any gain recognized to the transferor (sec. 362(a)).

Explanation of Provision

The bill provides that the contribution to capital rule will not apply if the shareholder is treated as having exchanged its stock (under sec. 302(a)). Thus, where section 302(a) applies, the acquiring corporation will be treated as purchasing the stock, for example, for purposes of section 338. The amendment is not intended to change the present law treatment of the shareholder (including the shareholder's basis in the stock of the acquiring corporation).

2. Miscellaneous pension provisions (sec. 1575(b) of the bill and secs. 62, 219, 402, 404, and 408 of the Code)

Present Law

Rollovers

Under the Code as in effect before the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a 10-percent additional income tax applied to certain premature distributions from a qualified plan to an owner-employee (a sole proprietor or a self-employed individual who owned more than 10 percent of a partnership. TEFRA extended the additional income tax to premature distributions made to key employees (sec. 426(i)(1)). TEFRA did not, however, provide a conforming amendment to prevent avoidance of the tax through tax-free rollovers.

The Deficit Reduction Act of 1984 (DEFRA) provided the conforming amendment with respect to tax-free rollovers and also applied the tax to individuals who are 5-percent owners of the employer, whether or not those individuals are key employees, but did not provide rules reflecting other change affecting 5-percent owners.

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Overall limits

Generally, effective for years ending after July 1, 1982, TEFRA reduced the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, or simplified employee pensions (SEPs). TEFRA also provided rules for calculating the dollar limits applicable to alternate forms of benefits, benefits commencing prior to age 62, and benefits commencing after age 65. In calculating employer contributions required to fund benefit amounts not in excess of those limits (and deductions for those contributions), TEFRA provided that anticipated cost-of-living increases are not taken into account.

Deduction limits for self-employed individuals

Generally, effective for years beginning after December 31, 1983, TEFRA revised the definition of earned income so that the amount taken into account as the earned income of a self-employed individual corrresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules relating to deductions and limitations under qualified plans, the earned income of a self-employed individual was computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions. TEFRA was designed to make it clear that the new definition of earned income did not apply for purposes of determining whether contributions made on behalf of a self-employed individual are ordinary and necessary business expenses.

Explanation of Provisions

Rollovers

The bill coordinates the rules relating to qualifying rollover distributions with those applicable to the additional income tax on early withdrawals. Under the bill, distributions made after July 18, 1984, but before the enactment of this bill, may not be rolled over to a qualified plan if any part of the distribution is a benefit attributable to contributions made on behalf of an employee while a key employee in a top-heavy plan. Distributions made after enactment of this bill to or on behalf of an individual who is a 5-percent owner at the time of distribution may not be rolled over to a qualified plan.

Overall limits

The bill makes it clear that the rule precluding anticipated cost-of-living adjustments to the overall benefit limits applies to limit benefits payable as a single life annuity commencing at age 62, as well as benefits paid in alternate forms, those commencing prior to age 62, and those commencing after age 65.

Excess contributions

The bill makes it clear that the Act's repeal of the rule relating to the return of excess contributions made on behalf of a self-employed individual applies with respect to contributions made in taxable years beginning after December 31, 1983.

IRAs, SEPs

The bill conforms the limits on certain distributions of excess IRA contributions and the limits on employer contributions on behalf of certain officers, shareholders, or owner employees to SEPs to conform with the dollar limit on annual additions to a qualified defined contribution plan.

Deduction limits for self-employed individuals

The bill makes it clear that the Act's amendment to the definition of earned income did not change the TEFRA definition of earned income for purposes of the 15- or 25-percent limits on deductions (sec. 404). Rather, the change permitting earned income of a self-employed individual to be determined without regard to the deductions allowable for contributions to a qualified plan is to apply solely for purposes of determining the extent to which contributions made to a qualified plan are ordinary and necessary business expenses for purposes of the deduction rules (sec. 404(a)(8)(C)).

The bill also clarifies that the deduction available to a self-employed individual for contributions to a qualified plan is not necessarily limited to the cost of actual benefits provided for, or allocations to, the individual. Rather, subject to the usual deduction rules (sec. 404), a self-employed individual is permitted to deduct the allocable share of contributions to a qualified plan. Thus, for example, any partner's share of total contributions to qualified plans is to be determined on the basis of partnership interests or, if the partnership agreement so provides, pursuant to the partnership special allocation provisions (sec. 704).

3. Effective date of provision relating to interest on tentative carrybacks and refund adjustments (sec. 1575(c) of the bill, sec. 6611(f) of the Code and sec. 714(n)(2) of the Act)

Present Law

The Act provided that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a tentative adjustment claim is filed, the refund is treated as filed on the date that the tentative adjustment claim is filed. Prior to this amendment, some taxpayers filed an amended return claiming a refund based on a carryback, waited until the expiration of the 45-day period within which, if a refund is made, no interest is paid, and then filed for a tentative adjustment, which provides for rapid payment. These taxpayers consequently defeated the intent of the interest rules relating to tentative adjustments by obtaining interest on the tentative adjustment relating back to the due date of the return for the year of the loss. The provision of the Act that prevented this misapplication of the intended rules relating to the payment of interest was added to the Act in conference and was effective as if it were included in the Tax Equity and Fiscal Responsibility Act of 1982.

Explanation of Provision

The bill provides that the provision of the Act (sec. 714(n)(2)) relating to interest on tentative carrybacks and refund adjustments

is effective only with respect to applications filed after July 18, 1984.

4. Foreign Sales Corporations

a. Treatment of income that a FSC earns without using administrative pricing rules (sec. 1576(a)(1) of the bill and secs. 927 and 1248 of the Code)

Present Law

In general, the Act exempts a fraction of the foreign trade income of a Foreign Sales Corporation (FSC) from tax. The fraction is 15/23 if the FSC uses an administrative pricing rule to determine its income (16/23 if the FSC shareholder is not a corporation). The Act generally denies foreign tax credits for taxes imposed on foreign trade income, but allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income.

Different rules apply, however, when a FSC does not use the Act's administrative pricing rules. Then, a fraction (generally 30 or 32 percent) of the FSC's foreign trade income is exempt from U.S. tax, and the balance (70 or 68 percent) is so-called "section 923(a)(2) non-exempt income." In general, this section 923(a)(2) non-exempt income is subject to one of three sets of pre-existing rules governing income of foreign corporations generally. It may be taxable currently to the FSC as income effectively connected with a U.S. trade or business. It may be taxable to the FSC's U.S. shareholders under the anti-avoidance rules of subpart F. It may be exempt from current taxation, and taxable only on repatriation to U.S. shareholders.

The Act makes this section 923(a)(2) non-exempt income ineligible for some treatment that it applies to other foreign trade income. For instance, foreign taxes on this income may be creditable, but distributions out of earnings and profits attributable to this income are not eligible for the 100-percent dividends received deduction.

Explanation of Provision

The bill conforms the treatment of effectively connected foreign trade income that a FSC earns *without* administrative pricing rules (effectively connected section 923(a)(2) non-exempt income) to that of other effectively connected foreign trade income. Taxes on that income are not creditable, but the bill allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income. That is, this income will be subject to full U.S. tax at the FSC level, but not again at the shareholder level.

b. Treatment of foreign trade income under section 1248 (sec. 1576(a)(2) of the bill and sec. 1248(d)(6) of the Code)

Present Law

Section 1248 treats gain realized by certain U.S. persons on the disposition of stock in a foreign corporation as ordinary income to the extent of allocable earnings and profits. The Act excluded all FSC earnings and profits attributable to foreign trade income from ordinary income treatment under section 1248, whether or not those earnings would have been eligible for the 100 percent dividends received deduction had the FSC distributed them.

Explanation of Provision

The bill refines the Act's restriction of section 1248 ordinary income treatment on disposition of FSC shares. It provides that FSC earnings and profits that would be taxable on a distribution are subject to ordinary income treatment under section 1248.

c. Clarification of corporate preference cutbacks (sec. 1576(b) and (i) of the bill and secs. 291, 923, and 995 of the Code)

Present Law

Present law provides for a reduction in certain corporate tax preferences. The Act, in extending this reduction of corporate preferences, sought to reduce the exempt portion of the foreign trade income of a FSC by 1/17 if the shareholder of the FSC is a corporation. The statute indicates that the cutback applies "with respect to" the corporate shareholder of the FSC. Congress intended that the cutback apply at the FSC level, which would reduce the portion of the FSC's foreign trade income that is exempt from tax at that level.

Present law provides a similar reduction in benefits in the case of deferred DISC income. A shareholder of a DISC is treated as having received a distribution taxable as a dividend equal to 1/17 of the excess of the taxable income of the DISC over certain other deemed distributions. The reduction in benefits applies whether or not the shareholder of the DISC is a corporation. Congress intended to limit this cutback to cases where the shareholder of the DISC is a corporation.

Congress intended that the amount of deemed DISC distribution attributable to international boycott activities be computed by multiplying 16/17 of the excess taxable income by the international boycott factor. Present law erroneously indicates that the deemed distribution is computed by multiplying 1/17 of the excess taxable income by the international boycott factor.

Explanation of Provision

The bill clarifies that the FSC preference cutback applies with respect to the FSC, rather than the corporate shareholder of the FSC. The exempt portion of foreign trade income is reduced from 32 to 30 percent in cases in which income is determined without regard to the administrative pricing rules, and from 16/23 to 15/23

in cases in which income is determined under the administrative pricing rules. The bill also provides that the portion of foreign trade income that is exempt will be adjusted, under regulations, to take into account any shareholders that are not C corporations for whom there is no preference cutback.

The bill also clarifies that the deemed distribution of 1/17 of the excess taxable income of the DISC applies only in the case of a shareholder which is a C corporation. Neither the FSC nor the DISC corporate preference cutback applies when an S corporation is the shareholder.

In addition, the bill corrects the method for computing the amount of the deemed distribution attributable to international boycott activities. This amount is computed by multiplying 16/17 of the excess taxable income by the international boycott factor.

d. Treatment of foreign trade income under subpart F (sec. 1576(c) of the bill and secs. 951 and 952 of the Code)

Present Law

The Act contains a sentence designed to prevent shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level. That sentence appears in a Code provision designed to prevent shareholder level taxation of earnings and profits attributable to most foreign trade income, whether or not taxed at the FSC level.

Explanation of Provision

The bill makes it clear that there is to be no shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level.

e. Dividends received deduction for certain distributions from a FSC (secs. 1576(d)(1) and 1576(j) of the bill and sec. 245 of the Code)

Present Law

Present and prior law allow an 85-percent dividends received deduction for dividends received from a foreign corporation if half or more of the foreign corporation's gross income (over a three-year period) is effectively connected with the conduct of a U.S. trade or business. This 85-percent deduction applies, on a pro rata basis, to the extent that the foreign corporation's gross income is effectively connected income.

The Act treats all interest, dividends, royalties, and other investment income received or accrued by a FSC as income effectively connected with a trade or business conducted through a permanent establishment in the United States. If enough of a FSC's income is effectively connected, the FSC will meet the 50-percent of gross income test that will qualify its U.S. corporate shareholders for the 85-percent dividends received deduction for dividends attributable to this passive income. If the FSC does not meet the 50-percent of gross income test, however, then none of its dividends attributable to passive income will be eligible for the 85-percent dividends re-

ceived deduction. Whether the FSC meets the 50-percent of gross income test depends on a number of factors.

The Act also provides a 100-percent dividends received deduction for distributions out of earnings and profits attributable to foreign trade income of a FSC other than section 923(a)(2) non-exempt income.

Explanation of Provision

In general, the bill provides an 85-percent dividends received deduction for any dividend received by a U.S. corporation from a FSC that is distributed out of earnings and profits attributable to "qualified interest and carrying charges." Qualified interest and carrying charges mean interest or carrying charges derived from a transaction that results in foreign trade income. Passive income that is not directly related to foreign trade income is not eligible for this treatment.

In addition, the bill specifies that gross income giving rise to earnings and profits attributable to foreign trade income or to qualified interest and carrying charges of a FSC will not be taken into account for purposes of calculating a dividends received deduction under the general rules (with respect to other income of the FSC). Thus, for example, such income will not be taken into account in determining whether a dividend attributable to such other income allows a dividends received deduction because half or more of the FSC's gross income is effectively connected with a U.S. trade or business.

f. Separate foreign tax credit limitation for FSC income (sec. 1576(d)(2) of the bill and sec. 904 of the Code)

Present Law

Distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income are subject to a separate foreign tax credit limitation.

Explanation of Provision

Under the bill, distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income or qualifying interest and carrying charges are subject to a separate foreign tax credit limitation. The purpose of this provision is to prevent this income from absorbing foreign tax credits from other income, and to prevent other income from absorbing foreign tax credits (if any are allowable) on this income.

g. Coordination of foreign tax credit for foreign corporations and deemed paid credit (sec. 1576(d)(3) of the bill and secs. 902 and 906 of the Code)

Present Law

A foreign corporation may credit foreign taxes imposed on income that is effectively connected with the conduct of a trade or business in the United States (sec. 906). A corporate U.S. shareholder owning 10 percent or more of the voting stock of a foreign corpo-

ration may be eligible for a deemed paid foreign tax credit when the corporation pays a dividend (sec. 902). This deemed paid credit allows such a U.S. shareholder to credit again the taxes that the foreign corporation paid. If enough of the foreign corporation's income is effectively connected, its U.S. shareholders may be eligible for a dividends received deduction for the dividends the foreign corporation pays them.

The Act makes all investment income of a FSC effectively connected income. It generally makes the taxable portion of foreign trade income of a FSC effectively connected income.

Explanation of Provision

The bill provides that taxes paid or accrued with respect to, and accumulated profits attributable to, income of a foreign corporation that is effectively connected with the conduct of a trade or business within the United States shall not be taken into account for purposes of the deemed paid credit. This provision is designed to prevent a double tax benefit.

h. Exchange of information requirements (sec. 1576(e) of the bill and sec. 927(e)(3) of the Code)

Present Law

A corporation (other than a corporation formed in an eligible U.S. possession) cannot qualify as a FSC unless there was in effect, at the time of creation or organization of the FSC, with the foreign country under whose laws it was created or organized, either (1) an agreement allowing tax benefits under the Caribbean Basin Initiative, or (2) an income tax treaty with respect to which the Secretary of the Treasury certifies that the exchange of information program with respect to the country carries out the purposes of paragraph 927(e)(3) of the Code. The purposes of that paragraph are not specified in the statute. An agreement under the Caribbean Basin Initiative must generally provide for disclosure for civil tax purposes of information that is otherwise confidential under local law, but may provide for nondisclosure of such information if the President determines that the agreement as negotiated is in the national security interest of the United States.

A FSC (other than a small FSC) must maintain its principal bank account outside the United States at all times during the taxable year.

Explanation of Provision

The bill provides that a corporation cannot continue to qualify as a FSC if its country of incorporation, having once qualified as a host country for FSCs, ceases to qualify. Notwithstanding a Treasury determination that a country ceases to qualify, under Treasury regulations, corporations established in that country continue to be eligible for FSC benefits for the six months following the determination.

The bill also makes it clear that a country may qualify as a host country for FSCs by entering into an exchange of information agreement of the type that allows tax benefits under the Caribbean

Basin Basin Initiative, whether or not that country is eligible to be a beneficiary of the Caribbean Basin Initiative. The bill also specifies that the national security exception under the Caribbean Basin Initiative will not apply for purposes of FSC; thus, to be acceptable for FSC purposes, an exchange of information agreement must require disclosure of confidential information.

The bill also makes it clear that an income tax treaty will allow a country to qualify as a host country for FSCs only if the Secretary certifies that its exchange of information program is satisfactory in practice for purposes of the Internal Revenue Code. That is, the program should provide to the United States in practice such information as may be relevant to the determination of a U.S. tax liability or whether a tax-related criminal offense has been committed.

In addition, the bill makes it clear that, for a corporation to qualify as a FSC, the exchange of information program of the country of its incorporation must cover that particular corporation. The bill makes it clear, for example, that a corporation incorporated in a treaty partner country but not subject to the exchange of information program of the treaty because it is not resident in the treaty partner does not qualify for FSC status.

The bill makes it clear that a FSC (other than a small FSC) must maintain its principal bank account in a possession of the United States or in a country that qualifies as a host country for FSCs at all times during the taxable year. This requirement is effective for periods after March 28, 1985.

i. Coordination with possessions taxation (sec. 1576(f) of the bill and sec. 927(e)(5) of the Code)

Present Law

Under present law, a possession of the United States may not impose a tax on any foreign trade income of a FSC that is derived before January 1, 1987. Foreign trade income is generally the gross income of a FSC attributable to the sale or lease of export property outside the United States. Thus, foreign trade income may be derived from the sale or lease of export property (or performance of services) within a U.S. possession by a FSC located in the possession. Congress intended, with respect to any foreign trade income or passive income of a FSC that a possession is permitted to tax, that the possession would also be permitted to exempt such income from tax. In some cases, U.S. tax imposed on certain income connected with a possession is covered over to the possession.

Explanation of Provision

The bill provides that a U.S. possession is not prohibited from imposing a tax on any income attributable to the sale of property or the performance of services for use, consumption or disposition within the possession. Thus, for example, the Virgin Islands is not prohibited from imposing a tax on the income derived from the sale of goods by a U.S. company, through its FSC located in the Virgin Islands, to customers in the Virgin Islands.

The bill clarifies that no provision of law may be construed as prohibiting a U.S. possession from exempting from tax any foreign trade income or passive income (e.g., interest, dividends or carrying charges) of a FSC. The bill also clarifies that no provision of law may be construed as requiring any income tax imposed by the United States on a FSC to be covered over (or otherwise transferred) to any U.S. possession.

j. Interest on DISC-related deferred tax liability (sec. 1576(g) of the bill and sec. 995(f) of the Code)

Present Law

A DISC may defer income attributable to $10 million or less of qualified export receipts. However, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income, computed as if the income were distributed.

Explanation of Provision

The bill clarifies that an interest charge is to be imposed on the deferred income of a former DISC in the same manner that it is imposed on a DISC.

k. Exemption of accumulated DISC income (sec. 1576(h) of the bill and sec. 805(b)(2) of the Act)

Present Law

Accumulated DISC income which is derived before January 1, 1985 is generally exempt from tax. This result is achieved by treating actual distributions made after December 31, 1984 by a DISC (or former DISC which was a DISC on December 31, 1984) as previously taxed income with respect to which there had previously been a deemed distribution. It is unclear under present law whether a distribution in liquidation is an "actual distribution" for purposes of this provision. It is also unclear how such a distribution would be treated for purposes of computing the earnings and profits of any corporate shareholder of the DISC.

Explanation of Provision

The bill clarifies that for purposes of exempting from tax accumulated DISC income, the term actual distribution includes a distribution in liquidation. The bill further clarifies that the earnings and profits of any corporation receiving a distribution that is not included in gross income because it is treated as previously taxed income under this provision will be increased by the amount of the distribution.

l. Effective date of tax year conformity requirement (sec. 1576(i) of the bill and sec. 805(a)(4) of the Act)

Present Law

In general, the taxable year of any DISC must be the taxable year of its owner. If the DISC has more than one shareholder, the

taxable year of shareholders with a plurality of voting power controls. This rule applies to any DISC established after March 21, 1984.

Explanation of Provision

The bill provides that the rule requiring conformity of tax years applies to taxable years beginning after December 31, 1984. The bill makes it clear that this rule will apply to interest-charge DISCs, whether or not newly formed.

m. Treatment of certain qualifying distributions from a DISC (sec. 1576(k) of the bill and sec. 996 of the Code)

Present Law

To qualify as a DISC, 95 percent of a corporation's gross receipts must be "qualified export receipts." If a corporation seeking to qualify as a DISC does not meet that 95-percent test for a year, it may, after that year's close, qualify retroactively by distributing to its shareholders property in an amount equal to taxable income attributable to gross receipts that are not qualified export receipts. Generally, under prior law, one-half of this kind of distribution to meet qualification requirements was treated as coming out of accumulated DISC income, and one-half was treated as coming out of previously taxed income. Under prior law, generally, one-half of a DISC's income was deemed distributed to its shareholders. The treatment of a distribution to meet qualification requirements was based on the notion that one-half of a DISC's taxable income attributable to all gross receipts had already been taxed as a deemed distribution, while the other half was deferred. Under the Act, one-seventeenth of a DISC's income is deemed distributed to shareholders that are C corporations.

Explanation of Provision

In the case of a shareholder that is a C corporation, the bill would treat $^{16}/_{17}$ of a DISC's distribution to meet the qualified export receipts requirement as coming out of accumulated DISC income, with generally only $^{1}/_{17}$ coming out of previously taxed income. This treatment reflects the post-1984 treatment of DISC income attributable to a shareholder that is a C corporation, whereunder only $^{1}/_{17}$ is deemed distributed and taxed currently.

n. Treatment of certain receipts from another FSC (sec. 1576(l) of the bill and sec. 924 of the Code)

Present Law

A FSC cannot treat as foreign trading gross receipts any receipts from another FSC that is a member of the same controlled group (Code sec. 924(f)(1)). The prohibition of sales through related FSCs prevents pyramiding of benefits under the gross receipts method of calculating income.

Explanation of Provision

The bill permits FSCs to treat receipts from another FSC that is a member of the same controlled group as foreign trading gross receipts, if no FSC in the group uses the gross receipts method of calculating income.

o. Treatment of certain former export trade corporations (sec. 1576(m) of the bill and sec. 805(b) of the Act)

Present Law

The Act provides that accumulated DISC income, in certain circumstances, will not be subject to U.S. tax. Similarly, the Act provides that certain income of active export trade corporations (as defined in Code sec. 971) will not be subject to U.S. tax, but only if the export trade corporation either elects to be treated as a FSC or surrenders its export trade corporation status.

Explanation of Provision

The bill extends to corporations that had been export trade corporations at some point but that were not export trade corporations for their most recent taxable years ending before July 18, 1984, the same treatment that the Act extended to active export trade corporations. To qualify for this treatment, a former export trade corporation either must be precluded (under statutory rules) from again qualifying as an export trade corporation, or must elect never again to qualify as such.

p. Distributions of accumulated DISC income received by cooperatives (sec. 1576(n) of the bill and sec. 805(b)(2) of the Act)

Present Law

The Act excludes from gross income certain distributions of accumulated DISC income. That exclusion applies to certain accumulated DISC income received by certain cooperative organizations.

Explanation of Provision

The bill provides that amounts excluded from the gross income of a cooperative organization described in Code section 1381 by sec. 805(b)(2)(A) of the Act will not be included in the gross income of the cooperative's members when distributed to them. Distributions arising from tax-free accumulated DISC income will not be deductible by the cooperative organization. This treatment reflects the concept that a cooperative organization is a flow-through entity analogous to a partnership for the purpose of the exclusion of certain accumulated DISC income from tax.

q. Effective date of certain FSC requirements (sec. 1576(o) of the bill and sec. 805(a) of the Act)

Present Law

The foreign management and foreign economic process requirements for eligibility for FSC benefits (Code sec. 924(c) and (d)) gen-

erally apply in taxable years ending after December 31, 1984. Transition rules are provided for existing contracts taken over by a FSC. Thus, those requirements do not apply with respect to contracts entered into (or planned to be entered into) before March 16, 1984, with respect to which the taxpayer uses the completed contract method of accounting. In addition, those requirements do not apply for the first two taxable years of a FSC ending after January 1, 1985, with respect to contracts entered into before March 16, 1984. Finally, those requirements do not apply for the first taxable year of a FSC ending after January 1, 1985, with respect to contracts entered into after March 15, 1984, and before January 1, 1985.

Code section 925(c) provides that a FSC may use the administrative pricing rules only if certain activities with respect to a sale are performed by or on behalf of the FSC. The Act did not provide a transition rule for this requirement.

Explanation of Provision

The bill provides that any requirement of Code section 924(c) or (d), or section 925(c) that should have been met before January 1, 1985, will be treated as having been met with respect to any lease entered into before that date for a period longer than three years. Those requirements will also be treated as having been met with respect to any contract entered into before January 1, 1985, with respect to which the taxpayer uses the completed contract method of accounting. Finally, in the case of any other contract entered into before January 1, 1985, those requirements will be treated as having been met, but only with respect to the first three taxable years of a FSC ending after January 1, 1985, or such later taxable years as the Secretary may prescribe.

5. Highway Revenue Provisions

a. Excise tax refund for diesel fuel used in school buses (sec. 1577(b) of the bill and sec. 6427(b) of the Code)

Present Law

The Act allows a complete refund of the 15-cents-a-gallon excise tax paid on diesel fuel which is used by private contractors to provide scheduled local bus service to the general public over regular routes, because the service substitutes for publicly provided service that would use tax-exempt fuel. However, the Act failed to provide a complete refund when private contractors supply school bus service, the diesel fuel for which would be tax-exempt if the service were supplied by a State or local government or nonprofit school. The effective excise tax rate on this fuel is 3 cents a gallon (tax of 15 cents a gallon, less refund of 12 cents a gallon), the effective rate that generally applies to diesel fuel used in privately operated buses.

Explanation of Provision

The bill allows a full 15-cents-a-gallon refund of excise tax on diesel fuel used in a school bus while engaged in the transportation of students and school employees.

b. Piggyback trailers (sec. 1577(c)) of the bill and sec. 4051(d)(3) of the Code)

Present Law

A 12-percent excise tax is imposed on the first retail sale of a heavy truck trailer. The Act temporarily reduced this excise tax rate to 6 percent for piggyback trailers (truck trailers equipped to be lifted onto and transported by railroad flatcars) sold after July 17, 1984, and before July 18, 1985. An additional tax is imposed if and when a trailer that was taxed at this reduced rate subsequently fails to qualify for it because, for example, the trailer is no longer used principally in connection with trailer-on-flatcar service. This additional tax equals the 6-percent excise tax that was not collected on the first retail sale by virtue of the temporarily reduced rate for piggyback trailers.

Explanation of Provision

The additional 6-percent excise tax imposed by section 4051(d)(3) will not apply to a piggyback trailer after 6 years have elapsed from the date of the first retail sale of the trailer.

6. Certain helicopter uses exempt from aviation excise taxes (sec. 1578(c) of the bill and secs. 4041 and 4261 of the Code)

Present Law

The Act expands the exemptions from the aviation excise taxes previously provided with respect to helicopters engaged in qualified timber and hard mineral resource activities where no FAA navigational facilities or airport are used to include helicopters engaged in qualified oil and gas activities.

Explanation of Provision

The bill clarifies that the exemptions for oil and gas activities are coterminous with those previously provided for hard mineral resource activities. Therefore, helicopters engaged in the exploration for, or the development or removal of, oil and gas will be exempt from the aviation excise taxes, provided the helicopters do not use Federally aided airports or Federal airway facilities.

7. Acquisition indebtedness of certain exempt organizations (sec. 1578(d) of the bill and sec. 514(c)(9) of the Code)

Present Law

The Act provided rules excepting certain debt-financed real estate held by qualified pension trusts and educational institutions from the unrelated business income tax. In the case where the exempt organization is a partner in a partnership (along with tax-

able entities), the Act provided that each allocation to the exempt organization be a qualified allocation, within the meaning of the tax-exempt entity leasing rules of section 168(j)(9).

Explanation of Provision

The bill provides that the Secretary may treat the qualified allocation rule as met if it is shown to the satisfaction of the Secretary that there is no potential for tax avoidance. For example, if the partnership elects 40-year straight-line depreciation on leased real estate and if the failure to meet the qualification allocation rule is caused by the allocation of an increased share of a loss or deduction to the exempt organization in order to meet the substantial economic effect requirement of section 704(b)(2), it is expected that the Secretary would treat the new rule as having been met.

8. Military housing rollover (sec. 1578(f) of the bill and sec. 1034(h)(2) of the Code)

Present Law

The Act provides an extended nonrecognition period for rollover of gain on sale of a personal residence in the case of military personnel stationed outside the United States, or required to reside in government quarters at certain remote base sites within the United States. In such a case, the nonrecognition rollover period otherwise allowable under Code section 1034(h)(1) is not to expire until the last day on which the person is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This provision applies to sales of old residences occurring after July 18, 1984.

Explanation of Provision

The extended nonrecognition period under Code section 1034(h)(2) is not to expire before the day which is one year after the last day on which the taxpayer is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This modification conforms the provision to the Senate amendment, which was adopted by the conference committee on the 1984 Act.

9. Effective date for disallowance of deduction for costs of demolishing structures (sec. 1578(g) of the bill and sec. 280B of the Code)

Present Law

Costs and other losses incurred in connection with the demolition of buildings must be added to the basis of the land on which the demolished buildings were located in all cases, rather than claimed as a current deduction. Before enactment of the Act, this rule ap-

plied only to certified historic structures. The expanded provision is effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The bill clarifies that the expanded prohibition on current deduction of costs and other losses incurred in connection with demolition applies only to demolitions commencing after July 18, 1984, in the case of buildings other than certified historic structures. For this purpose, if a demolition is delayed until the completion of the replacement structure on the same site, the demolition shall be treated as commencing when construction of the replacement structure commences.

A transitional rule is provided in a specified case where plans for the demolition were in place on July 18, 1984.

10. Regulated investment companies (sec. 1578(i) of the bill and sec. 852 of the Code)

Present Law

All regulated investment companies (RICs) are required to comply with regulations prescribed by the Treasury for the purpose of ascertaining its stock ownership (sec. 852(a)(2)). Under present law, as modified by the Act, a personal holding company may be eligible to be a RIC. The Act provided that any investment company taxable income of a RIC that is a personal holding company is taxed at the highest rate applicable to corporations.

Explanation of Provision

The provisions of the Act that permitted personal holding companies to qualify as RICs eliminated the necessity for a RIC to keep shareholder records that were intended to assure that it was not a personal holding company and thereby could qualify as a RIC. Accordingly, the bill eliminates the requirement that adequate shareholder records must be kept in order for a corporation to qualify as a RIC. Nevertheless, the bill provides that the investment company taxable income of a RIC that does not keep such records would be subject to tax at the highest corporate rate, since such treatment is provided for RICs that are personal holding companies.

11. Waiver of estimated tax penalties (sec. 1579(a) of the bill)

Present Law

Under present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to file estimated tax returns and make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax on the amount of underpayment for the period of underpayment (secs. 6654 and 6655, with the rate as determined under sec. 6621).

The Act, enacted on July 18, 1984, made several changes which increased tax liabilities from the beginning of 1984.

Explanation of Provision

The bill allows individual taxpayers until April 15, 1985, and corporations until March 15, 1985 (the final filing dates for calendar year returns) to pay their full 1984 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by the Tax Reform Act of 1984.

In order to minimize any administrative problems to the Internal Revenue Service, it will be expected that taxpayers notify the IRS if they are entitled to the benefits of this provision. The IRS will not be required to notify taxpayers of possible relief under this provision.

12. Orphan drug credit (sec. 1579(b) of the bill and sec. 28 of the Code)

Present Law

A 50-percent tax credit is available for qualified clinical testing expenses that are necessary to obtain the approval of the Food and Drug Administration for the commercial sale of a drug for a rare disease. The term "clinical testing" is defined, in part, by reference to the date on which an application with respect to a drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act. The term "rare disease or condition" is defined as any disease or condition that occurs so infrequently in the United States that the taxpayer has no reasonable expectation of recovering the cost of developing and marketing a drug for such disease from sales in the United States.

Explanation of Provision

The bill clarifies that, in the case of a drug that is a biological product, "clinical testing" is defined, in part, by reference to the date on which a license for such drug is issued under section 351 of the Public Health Services Act. The bill also redefines the term "rare disease or condition" as any disease that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available a drug for such disease in the United States will be recovered from sales of such drug in the United States. This will conform the provisions of the tax credit with the provisions of the Federal Food, Drug, and Cosmetic Act.

The amendments apply to amounts paid or incurred after December 31, 1982.

13. Credit for producing fuel from nonconventional source (sec. 1579(c) of the bill and sec. 29 of the Code)

Present Law

Present law provides a credit for certain fuels produced by a taxpayer and sold to an unrelated party.

Explanation of Provision

The bill provides that the credit may be allowed where the sale to an unrelated person is made by a corporation which files a consolidated return with the corporation producing the fuel. The provision applies as if included in section 231 of the Crude Oil Windfall Profit Tax Act of 1980.

14. Report of refunds by Joint Committee to Congress (sec. 1579(e) of the bill and sec. 6405(b) of the Code)

Present Law

The Code (sec. 6405(b)) requires the Joint Committee on Taxation to make an annual report to Congress setting forth the proposed tax refunds and credits submitted by the Internal Revenue Service to the Joint Committee for its review, including the names of the taxpayers and amounts involved. It is unclear whether this requirement was overridden by the tax return disclosure limitations (sec. 6103) enacted in 1976. Because of this apparent conflict, these reports have not been submitted in recent years and the Joint Committee believes it appropriate to delete the requirement to submit this report.

Explanation of Provision

The bill repeals the requirement that the Joint Committee on Taxation submit an annual report to Congress on proposed IRS tax refunds and credits.

15. Rural electric cooperative cash or deferred arrangements (sec. 1579 of the bill and sec. 401(k) of the Code)

Present Law

Under the Code, gross income may include amounts actually or constructively received as income. For example, under the rules of constructive receipt, the gross income of an individual includes compensation that has been earned and that would have been received but for the individual's election to defer its receipt. The Code provides for an exception to the rules of constructive receipt in the case of employer contributions under a qualified cash or deferred arrangement.

If a tax-qualified profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) meets certain requirements (a qualified cash or deferred arrangement), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Because a qualified stock bonus plan is generally required to distribute benefits in the form of employer stock, a qualified stock bonus plan may not be maintained by a governmental unit or by a tax-exempt membership organization. Under the Code, employer contributions to a qualified profit-sharing plan may be made only from preset or accumulated employer profits.

It is unclear under present law whether an employer that is a governmental entity or a tax-exempt organization may maintain a qualified cash or deferred arrangement because such an organization may not have stock or profits in the usual sense of those terms.

Explanation of Provision

The bill clarifies that any organization that is exempt from tax and that is engaged primarily in providing electric service on a mutual or cooperative basis is eligible to maintain a qualified cash or deferred arrangement. This provision also applies to a national association of such tax-exempt organizations.

16. Definition of newly discovered oil (sec. 1579(h) of the bill and sec. 4991 of the Code)

Present Law

Under the present law, the windfall profit tax is imposed at a lower rate on newly discovered oil than on other oil. Generally, the term "newly discovered oil" has the meaning given to it by the June 1979 energy regulations.

The legislative history to the Crude Oil Windfall Profit Tax Act of 1980 indicates that the term was also to include production from a property which did not produce oil in commercial quantities during calendar year 1978. That history indicates that it includes production from a property on which oil was produced in 1978 if that production was incident to the drilling of exploratory or test wells and was not part of continuous or commercial production from the property during 1978.

Explanation of Provision

The bill clarifies that the term "newly discovered oil" includes production from a property so long as not more than 2200 barrels was produced from the property in 1978 and no well on the property was in production for more than 3 days during that year (whether or not the oil was sold). This provision is intended to clarify the "test well" exception described in the Conference Committee Report accompanying the Crude Oil Windfall Profit Tax Act of 1980. No inference is intended as to the application of similar principles in areas other than section 4991(e)(2).

17. Refunds with respect to medicinal alcohol (sec. 1579(i) of the bill, and sec. 7652 of the Code)

Present Law

Under present law, a special excise tax is imposed on articles coming into the United States from Puerto Rico or the Virgin Islands, equal to the tax that would be imposed if the article were manufactured in the United States (sec. 7652).

Explanation of Provision

The bill clarifies that medicinal alcohol produced in Puerto Rico and the Virgin Islands is eligible for refunds of the tax on distilled spirits paid when the alcohol is brought into the United States. For purposes of the refunds, Puerto Rican and Virgin Islands producers of medicinal alcohol are treated as United States persons, except the amount of the refund is determined as if tax were paid at the rate eligible for cover over under section 7652.

18. Clerical amendments

The bill contains numerous minor clerical, typographical and conforming amendments.

H. Effective Dates

Except as otherwise described, the amendments made by the Technical Corrections title to the tax provisions will take effect as if included in the original legislation to which each amendment relates.

I. Revenue Effect

The amendments made by the Technical Corrections title to the tax provisions will reduce fiscal year budget receipts by $182 million in 1986, $18 million in 1987, $17 million in 1988, $14 million in 1989 and $13 million in 1990.

TECHNICAL CORRECTIONS IN OTHER PROGRAMS AFFECTED BY THE DEFICIT REDUCTION ACT OF 1984

A. Technical Corrections to Social Security Act Programs

1. Special Social Security Treatment for Church Employees (sec. 1585 of the bill, sec. 2603 of the Act, secs. 1402 and 3121 of the Code and sec. 211 of the Social Security Act)

a. Application to members of certain religious faiths

Present Law

The Act allows a church or qualifying church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. If an election is made to exclude services for FICA purposes, the employee is treated similarly to a self-employed person with respect to those services. Thus, the employee is liable for self-employment ("SECA") taxes on remuneration for such services. The amount of remuneration on which an employee of an electing organization is liable for SECA tax is generally the same as the amount which would have been subject to FICA tax in the absence of an election.

Under section 1402(g) of the Code, an exemption from SECA taxes is provided for self-employed members of a religious sect (e.g., the Amish) who are adherents of established tenets or teachings of that sect, by reason of which such individuals are conscientiously opposed to public or private death, retirement, or medical insurance (including social security). This exemption is not available to employees. This exemption is granted only upon application by the individual, which must include evidence of the sect's tenets or teachings and of the individual's adherence to them. To obtain an exemption, the individual must waive all social security benefits.

Explanation of Provision

The bill makes clear that the exception from SECA taxes for members of certain religious faiths (sec. 1402(g)) is not available for services with respect to which SECA tax is due as a result of an election under the Act. Thus, if a member of a religious faith covered by the sec. 1402(g) exception is an employee of a church or church-controlled organization, and that church or organization elects to treat the employee as self-employed for FICA tax purposes, the employee cannot also claim a section 1402(g) exception from SECA taxes with respect to those services. This provision prevents the combination of an election under the Act, and a section 1402(g) exception, from resulting in an avoidance of any employment taxes on the services performed for the electing organization. This is consistent with the general principle that the tax for serv-

ices covered by an election should be determined (to the extent possible) as it would be under FICA, for which the section 1402(g) exception would be unavailable. The provision does not affect the individual's ability to claim a section 1402(g) exception with respect to other services not covered by an election under the Act.

b. Computation of income subject to SECA tax

Present Law

Under the Act, the remuneration on which the employee of an electing church or organization is liable for SECA tax generally is the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, trade or business expenses are not subtracted in computing self-employment income (reimbursed business expenses are not included in self-employment income, however), and the $400 threshold generally applicable to self-employment income does not apply. Similarly, a $100 threshold (per employer) for a taxable year applies in determining whether remuneration for services covered by an election is subject to SECA tax. However, after 1989 these employees will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Explanation of Provision

The bill provides several changes to insure that church employee income will be determined, as far as possible, using FICA principles, and that the taxation of other self-employment income will not be affected by an election. Specifically, the bill specifies that the SECA tax base for services covered by an election is to be computed in a separate "basket" from the tax base for other self-employment income. Thus, church employee income is not reduced by any deduction, while other income and deductions are not affected by items attributable to church employee income.[12] (This rule does not apply to the deduction for the product of all net self-employment earnings and one-half the SECA tax rate, beginning after 1989). Additionally, the $100 threshold for taxing church employee income, and the $400 threshold applicable to other self-employment income, are separately applied under the bill (i.e., church employee income does not count toward the general $400 threshold).

This provision is effective only for remuneration paid or derived in taxable years beginning on or after January 1, 1985.

c. Voluntary revocation of election

Present Law

Under the Act, a church or organization must make an election to treat services performed for the church or organization as subject to SECA (rather than FICA) taxes before its first quarterly employment tax return is due, or if later, 90 days after July 18, 1984.

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[12] The "optional" method of computing self-employment income would apply only to non-church employee income.

Once made, that election may not be revoked by the church or organization. However, an election is to be permanently revoked by the Treasury Department if the electing church or organization fails to provide required information regarding its employees for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. (This information is required in order to monitor compliance with the provisions of the Act.) This rule could allow an electing church or organization effectively to revoke its election by failing to provide the required information.

Explanation of Provision

The bill allows a church or organization to revoke an election under regulations to be prescribed by the Treasury Department. The Treasury Department would continue to be permitted to revoke an election for failure to provide required information, as under present law. A church or organization which revokes an election (or for which the election is revoked) could not make another election, because the time for making such an election would have lapsed.

2. Amendments to the Medicare Program

a. Corrections relating to enrollment and premium penalty under the working aged provision (sec. 1586 of the bill and secs. 1839(b) and 1837(i) of the Social Security Act)

Present Law

Under current law, employers are required to offer to employees age 65 through 69, and employees with spouses age 65 through 69, the same health benefit plan they offer to their other employees. Where the employee or spouse choose the employer plan, medicare becomes the secondary payor.

Aged employees or aged spouses may wish to delay their enrollment in medicare because the coverage may be duplicative of the employer plan. However, persons who enroll in part A or part B late are subject to a penalty. The monthly premium is increased by 10 percent for each 12 months that an individual delays enrollment in medicare beyond his or her initial enrollment period at age 65. In addition, after the initial enrollment period, a person may enroll in medicare only during the annual enrollment period in January, February, and March.

The Deficit Reduction Act (P.L. 98-369) created a special enrollment period and waived the enrollment penalty for the working aged (and aged spouses) under certain circumstances. DEFRA provided a special enrollment period for persons who did not elect medicare because of coverage at the time under an employer plan and who lose such employer coverage or turn age 70. However, there is an anomaly in the law in that individuals who did not enroll during an initial enrollment period (even though the reason for nonenrollment may have been coverage under the employer plan) have only one special enrollment period, while persons who enrolled in the initial enrollment period, but later terminated coverage when covered under an employer plan, may have more than one special enrollment period.

DEFRA also forgives the premium penalty in certain cases. The provision currently forgives the penalty for those months in which an individual is enrolled in an employer group health plan related to the current employment of the individual (or the individual's spouse), is under 70 years of age, and is entitled to medicare part A (that is, meets the eligibility requirements and has filed an application for part A).

Explanation of Provision

The bill corrects the anomaly in the special enrollment provision which permits only one special enrollment period for an individual who was covered under an employer plan during his initial enrollment period and therefore did not enroll during such period. The

bill gives such an individual unlimited special enrollment periods so long as the person was enrolled in medicare during any periods during which he or she was not covered by an employer group health plan.

The bill also forgives the premium penalty for months in which an individual is enrolled in an employer group health plan related to the current employment of the individual (or the individual's spouse) and is 65 years of age or over. This drops the requirement that a person be entitled to part A by virtue of having met the eligibility requirements and having filed for part A benefits. It is recognized that this may provide forgiveness for certain workers 65 years of age and over (or aged spouses of workers) whose employer coverage is secondary to medicare.

b. Miscellaneous corrections (sec. 1586 of the bill)

The bill makes certain corrections in spelling, language and indentation in title XVIII of the Social Security Act.

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B. Technical Corrections to Unemployment Compensation Programs and Public Assistance Programs

1. Limitation on the Federal Unemployment Tax Act (FUTA) Credit in States Meeting the Solvency Requirements of Section 1202 of the Social Security Act (sec. 1590(2) of the bill and sec. 3302(f) of the Code)

Present Law

Under present law, States can borrow funds from the Federal Unemployment account if they have insufficient funds in their own unemployment accounts to pay unemployment benefits. Depending on the month in which such a loan is advanced, a State has between 22 and 34 months to repay the loan. If the loan is not repaid in time, the FUTA tax credit for employers in the State is reduced by .3% for each year the loan is in arrears.

The Social Security Act Amendments of 1983 provided for a partial limitation on the FUTA credit reduction in States that take legislative steps to improve the solvency of their unemployment insurance systems. If States meet the solvency test, the FUTA credit reduction is limited to .1% a year for each year a State has a loan in arrears. This limitation on the FUTA credit reduction is in effect for calendar years 1983, 1984 and 1985.

Explanation of Provision

The bill clarifies that the limitation on the FUTA credit reduction in States meeting the solvency test of Section 1202 of the Social Security Act expires at the end of calendar year 1985.

2. Reference to Agricultural Crew Leaders in the Federal Unemployment Tax Act (FUTA) (sec. 1590(3) of the bill and sec. 3306 of the Code)

Present Law

Section 3306(O)(A)(i) of the Internal Revenue Code provides that for purposes of the Federal Unemployment Tax Act an individual who is a member of a crew furnished by a crew leader to perform agricultural labor for any other person shall be treated as an employee of such crew leader if such crew leader holds a valid certificate of registration under the Farm Labor Contractor Act of 1963. This act has been repealed and replaced with the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

Explanation of Provision

The bill strikes the reference in section 3306 of the Internal Revenue Code of 1954 to the Farm Labor Contractor Act of 1963 and

replaces it with a reference to the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

3. Federal Incentive Payments in Cases of Interstate Collections (sec. 1587(b)(4) of the bill and sec. 458(d) of the Social Security Act)

Present Law

P.L. 98-378 made a number of amendments to the child support enforcement program. Several of these amendments were designed to encourage States to enforce the more complicated interstate child support obligations which arise when the custodial parent and child(ren) live in one State and the noncustodial parent lives in another State.

Section 458(d) of the Social Security Act as established by P.L. 98-378 provides that in interstate cases "support which is collected by one State on behalf of individuals residing in another State shall be treated as having been collected in full by each such State." As a result, in interstate collection efforts, both States are to be credited with the collection for the purposes of calculating the incentive payment.

Explanation of Provision

The bill clarifies the intent of Congress that the incentive be credited to both the State initiating the collection and the State making the collection. It describes the initiating State as the State requesting the collection, rather than the State of residence of the individuals on whose behalf the collection is made. The change is necessary because the State of residence is not always the same as the State initiating the collection request.

C. Technical Corrections to Trade and Tariff Program

1. Amendments to the Tariff Schedules (sec. 1591 of the bill, various provisions of the Tariff Schedules of the United States (TSUS), and Title I of the Trade and Tariff Act of 1984)

a. Telecommunications product classification corrections (sec. 1591(1) of the bill, various provisions of the TSUS, and sec. 124 of the Trade and Tariff Act of 1984)

Present Law

The provisions of part 5 of schedule 6 of the Tariff Schedules applicable to telecommunications products were revised, without changes in rates of duty, under section 124 of the Trade and Tariff Act of 1984, in order to better reflect the state of current technology in such products in the TSUS.

Explanation of Provision

The bill makes conforming changes to several headnotes in the Tariff Schedules which refer to the TSUS items in part 5 of schedule 6 which were changed by section 124 of the Trade and Tariff Act of 1984. It would also add the appropriate column 2 rate of duty for new item 685.34 which was inadvertently omitted from the Act.

b. Miscellaneous corrections (sec. 1591 (2) and (3) of the bill, various provisions of the TSUS, and secs. 111, 112, 123, 146, and 182 of the Trade and Tariff Act of 1984)

The bill makes corrections in the article descriptions of TSUS items 906.38, 907.38, 912.13 and in headnote 1 of the part 4D of schedule 1 and headnote 1 of part 4C of schedule 3, as amended by sections 111, 112, 123, 146, and 182 of the Trade and Tariff Act of 1984, in order to correct spelling, utilize proper chemical nomenclature, correct TSUS references and eliminate duplication.

c. Silicon electrical steel (sec. 1591 of the bill, various provisions of the TSUS)

Present Law

Item 607.92 of the TSUS covers silicon electrical steel plates and sheets of any width or thickness. However, item 608.39, the only TSUS item applicable to silicon electrical steel strip, limits coverage thereunder to electrical strip "over 0.01 but not over 0.05 inch".

Explanation of Provision

The bill adds a new item 608.25 to the TSUS covering silicon electrical steel strip not over 0.1 inch in thickness, providing for the same rates of duty currently applicable to such product. The purpose of this provision is to preclude foreign countries from circumventing the bilateral voluntary restraint agreements entered into pursuant to the Steel Import Stablization Act of 1984, by simply altering the configuration of the silicon electrical steel they ship to the United States to avoid being counted against the quota for silicon electrical steel. This amendment corrects an anomaly and maintains the Tariff Schedule's intended degree of control on shipments of this product.

2. Technical Corrections to Countervailng and Antidumping Duty Provisions (sec. 1592 of the bill, Title VII of the Tariff Act of 1930 and sec. 626(b) of the Trade and Tariff Act of 1984)

a. Definition of "interested party" (sec. 1592(a)(2) of the bill and secs. 702(b)(1), and 732(b)(1) of the Tariff Act of 1930)

Present Law

Section 612(a)(3) of the Trade and Tariff Act of 1984 amended section 711(9) of the Tariff Act of 1930 to include industry-labor coalitions within the definition of "interested party" for purposes of countervailing duty or antidumpting investigations, and section 612(b)(2) made conforming amendments to sections 704(g)(2) and (h)(1) and 734 (g)(2) and (h)(1).

Explanation of Provision

The bill makes similar conforming changes in sections 702(b)(1) and 732(b)(1) of the Tariff Act of 1930 to ensure that industry-labor coalitions will be considered proper petitioners under the countervailing duty and antidumping laws.

b. Imports under suspension agreements (sec. 1592(a)(4) of the bill and sec. 704 of the Tariff Act of 1930)

Present Law

Section 704(b) of the Tariff Act of 1930 authorizes the suspension of countervailing duty investigations if the foreign government or exporters accounting for substantially all imports of the merchandise agree to eliminate or offset the subsidy or to cease exports of the subsidized merchandise within 6 months after the suspension.

Explanation of Provision

The bill restores section 704(d)(2) of the Tariff Act of 1930, which was inadvertently deleted when House provisions deleting the 6-month grace period were not agreed to in House-Senate conference on the Trade and Tariff Act of 1984. Section 704(d)(2) requires that a suspension agreement provide a means of ensuring that exports shall not surge during the 6-month period of phase-in of measures to eliminate or offset subsidies.

The provision also corrects a typographical error in section 704(i)(1)(D) of the Tariff Act of 1930.

c. Waiver of deposit of estimated antidumping duties (sec. 1592(a)(7) of the bill and sec. 7369(c)(1) of the Tariff Act of 1930)

Present Law

Section 736(c)(1) of the Tariff Act of 1930 authorizes the administering authority for 90 days after publication of an antidumping order to continue to permit entry of merchandise subject to the order under bond in lieu of the deposit of estimated duties for individual importers if it has reason to believe these importers have taken steps to eliminate or substantially reduce dumping margins. This provision covers all merchandise entered as of the date of the first affirmative antidumping determination, i.e., whether or not sold to an unrelated purchaser which is necessary to compute price.

Explanation of Provision

The bill amends section 736(c)(1) of the Tariff Act of 1930 to change its scope to cover only entries entered and resold to unrelated purchasers during the period between the first affirmative antidumping determination and the Interntional Trade Commission's final affirmative determination. This amendment was inadvertently omitted from the Trade and Tariff Act of 1984 as enrolled.

d. Revocation of orders (sec. 1592(a)(8) of the bill, sec. 751(b)(1) of the Tariff Act of 1930, and sec. 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984)

Present Law

Section 751(b)(1) of the Tariff Act of 1930 as amended by section 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984 clarifies that the party seeking revocation of an antidumping order has the burden of persuasion as to whether there are changed circumstances sufficient to warrant revocation.

Explanation of Provision

The bill amends section 751(b)(1) of the Tariff Act of 1930 to apply the same standard to revocations of countervailing duty orders as applies to antidumping orders. The amendment corrects an inadvertent omission from the Trade and Tariff Act of 1984 since there is no reason to distinguish between the two types of revocations.

e. Definition of upstream subsidies (sec. 1592(a)(10) of the bill, sec. 771A(a) of the Tariff Act of 1930, and sec. 613 of the Trade and Tariff Act of 1984)

Present Law

Section 771A(a) of the Tariff Act of 1930 as added by section 613 of the Trade and Tariff Act of 1984 defines "upstream subsidies" in part in terms of the types of practices described under section 771(5)(B)(i)(ii), or (iii) of the Tariff Act as domestic subsidies.

Explanation of Provision

The bill amends section 771A(a) of the Tariff Act of 1930 to correct the unintended omission of section 771(5)(B)(iv) from the list of domestic subsidy practices which may constitute an upstream subsidy.

f. Release of confidential information (sec. 1592(a)(13) of the bill, sec. 777 of the Tariff Act of 1930, and sec. 619 of the Trade and Tariff Act of 1984)

Present Law

Section 777 of the Tariff Act of 1930 contains various provisions relating to the release of confidential information. As amended by section 619 of the Trade and Tariff Act of 1984, section 777(b)(1)(B)(i) provides that the administering authority may release such information under an administrative protective order if it is accompanied by a statement of permission.

Explanation of Provision

The bill amends section 777 of the Tariff Act of 1930 to substitute the term "proprietary" for "confidential" throughout the section, a change that was omitted inadvertent from the Trade and Tariff Act of 1984 as enrolled. The provision also amends subsection (b)(1)(B)(i) to correct the inadvertent omission of the International Trade Commission as being permitted to release information, as well as the administering authority, consistent with the rest of the section.

g. Effective dates (sec. 1592(b) of the bill and sec. 626(b) of the Trade and Tariff Act of 1984)

Present Law

Section 626(b) of the Trade and Tariff Act of 1984 made the amendments in sections 602, 609, 611, 612, and 620 of that Act to Title VII of the Tariff Act of 1930 applicable with respect to investigations initiated on or after date of enactment and the amendments made by section 623 were made applicable to civil actions pending or filed on or after date of enactment.

Explanation of Provision

The bill amends paragraph (1) of section 626(b) of the Trade and Tariff Act of 1984 so that the amendments in sections 602, 609, 611,

612, and 620 of the Act will apply to reviews of outstanding antidumping and countervailing duty orders, as well as to new investigations. These orders would involve merchandise entered, or withdrawn from warehouse, for consumption many years after date of enactment. This amendment is consistent with the Congressional intent of these amendments to reduce the cost and increase the efficiency of proceedings.

The bill authorizes the administering authority to delay implementation of any of the amendments to Title VII with respect to investigations in progress on the date of enactment of the Trade and Tariff Act of 1984 if it determines that immediate implementation would prevent compliance with an applicable statutory deadline. New questionnaires would have to be issued to seek information required by certain amendments that may not be obtainable on cases in progress within the statutory deadlines.

The bill also clarifies that the amendment made by section 621 of the Trade and Tariff Act of 1984 to section 778 of the Tariff Act of 1930 concerning the rate of interest payable on overpayments and underpayments of antidumping and countervailing duties is applicable to merchandise unliquidated as of five days after date of enactment, i.e., on or after November 4, 1984, consistent with U.S. Customs Service practice.

h. Miscellaneous corrections (sec. 1592(a) (1), (3), (5), (6), (9), (11), and (12) of the bill)

The bill corrects errors in various provisions of Title VII of the Tariff Act of 1930 concerning subsection designations, cross-references, and printing, grammatical, and typographical errors and provides for the addition of a section heading.

3. Amendments to the Trade Act of 1974 (sec. 1593 of the bill, various sections of the Trade Act of 1974)

a. Miscellaneous corrections (sec. 1593 (1), (2), (3), and (4) of the bill)

The bill makes certain corrections of numbers, subsection designations, cross-references to the United States Code and syntax in amendments to various sections of the Trade Act of 1974 made by the Trade and Tariff Act of 1984.

b. Waiver authority under Generalized System of Preferences (GSP) (sec. 1593 (5) of the bill, sec. 504(c)(3)(D)(ii) of the Trade Act of 1974, and sec. 505 of the Trade and Tariff Act of 1984)

Present Law

Section 504(c)(3)(D)(ii) of the Trade Act of 1974 as added by section 505 of the Trade and Tariff Act of 1974 limits as the President's authority to waive more restrictive GSP competitive need limits with respect to products from advanced beneficiary developing countries to no more than 15 percent of the total value of GSP duty-free imports during the preceding calendar year.

Explanation of Provision

The bill clarifies that the 15-percent limit on the President's waiver authority under section 504(c)(3)(D)(ii) of the Trade Act of 1974 as amended applies to the aggregate value of all waivers granted in a given year with respect to GSP imports from advanced beneficiary countries as a whole, not to each country individually.

4. Amendments to the Tariff Act of 1930 (sec. 1594 of the bill, secs. 304(c) and 313(j) of the Tariff Act of 1930, and secs. 202 and 207 of the Trade and Tariff Act of 1984)

a. Marking of pipes and tubes (sec. 1594 (1) of the bill, sec. 304(c) of the Tariff Act of 1930, and sec. 207 of the Trade and Tariff Act of 1984)

Present Law

Section 207 of the Trade and Tariff Act of 1984 adds a new subsection (c) to section 304 of the Tariff Act of 1930 providing that no exceptions may be made to the marking requirements of section 304 for certain pipes and pipe fittings and requires such products to be marked with the country of origin by means of die stamping, cast-in-mold lettering, etching, or engraving.

Explanation of Provision

The bill provides a limited exception to the above marking requirement for articles which, due to their nature, may not be marked by one of the four prescribed methods because it is technically or commercially infeasable to do so. Such articles may be marked by an equally permanent method of marking, such as paint stenciling, or in the case of small diameter pipe and tube, by tagging the containers or bundles. Those articles which Customs has determined are capable of being marked by die stamping, cast-in-mold lettering, etching or engraving without adversely affecting their structural integrity or significantly reducing their commercial utility would continue to be marked in this manner.

Further, the tagging of containers or bundles may only be used for small diameter pipes and tubes for which individual marking would be impractical or inconspicuous. In the event that Customs determines that tagging is the only feasible method of marking imported goods so that the ultimate consumer will be appraised of the country of origin of such goods, such products must be bundled and tagged in accordance with applicable industry standards. The Committee directs the U.S. Customs Service to report to the Committee on the operation and effectiveness of this provision within one year after the enactment of this Act.

b. Drawback—incidental operations (sec. 1594)(2) of the bill, sec. 313(j) of the Tariff Act of 1930, and sec. 202 of the Trade and Tariff Act of 1984)

Present Law

Section 202 of the Trade and Tariff Act of 1984 amends section 313(j) of the Tariff Act of 1930 to allow for the substitution of do-

mestic fungible merchandise for imported merchandise under prescribed circumstances and still receive the benefits of drawback when such products are exported. However, incidental operations which may be performed on imported merchandise under section 313(j)(4) without depriving them of drawback privileges may not be performed on such substituted domestic merchandise.

Explanation of Provision

The bill redesignates paragraphs (3) and (4) of section 313 as (2) and (3), respectively, and amends paragraph (3) as redesignated so that incidental operations may be performed on both domestic and imported merchandise so that the intent of the original provision (i.e., allowing fungible domestic and imported merchandise to be mixed together and still be entitled to drawback) is accomplished.

c. Interested parties (sec. 1594 (4) and (5) of the bill and secs. 514(a) and 516(a)(2) of the Tariff Act of 1930)

Present Law

Section 771(9) of the Tariff Act of 1930, as amended by section 612(a) of the Trade and Tariff Act of 1984, defines the term "interested party" for purposes of countervailing duty or antidumping proceedings to include industry-labor coalitions. The term is also used in the provisions for judicial review of such proceedings under Title V of the Tariff Act of 1930.

Explanation of Provision

The bill amend sections 514(a) and 516(a)(2) of the Tariff Act of 1930 to conform the definition of the term "interested party" to the inclusion of industry-labor coalitions under section 771(9) of the Tariff Act of 1930.

d. Miscellaneous corrections (sec. 1594(3) and (6) of the bill and secs. 339(c)(2)(A) and 516A(a)(3) of the Tariff Act of 1930)

Section 1594(3) of the bill corrects a cross-reference to a title in section 339(c)(2)(A) of the Tariff Act of 1930, as added by section 221 of the Trade and Tariff Act of 1984. Section 1594(6) of the bill corrects an erroneous paragraph reference in section 516A(a)(3) of the Tariff Act as amended by section 623(a)(4) of the Trade and Tariff Act of 1984.

5. Amendments to the Trade and Tariff Act of 1984 (sec. 1595 of the bill, secs. 126, 174(b), 212, 234(a), 304(d)(2)(A), 307(b)(3), and 504 of the Trade and Tariff Act of 1984)

a. Chipper knife steel (sec. 1595(1) of the bill and sec. 126 of the Trade and Tariff Act of 1984)

Present Law

Section 126 of the Trade and Tariff Act of 1984 amends the Tariff Schedules of the United States (TSUS) to reduce the duty on imports of chipper knife steel in two stages on April 1, 1985; and April 1, 1986.

Explanation of Provision

The bill amends section 126 to eliminate a duplication and correct the rate of duty that will apply at the first stage of the duty reduction.

b. Watch glasses (sec. 1595(2) of the bill and sec. 174(b) of the Trade and Tariff Act of 1984)

Present Law

Section 174 of the Trade and Tariff Act of 1984 reduced the level of duty on watch glasses other than round to the same level as the duty applicable to round watch glasses. However, the Act does not provide for the third-year staged reduction on January 1, 1987, for watch glasses other than round.

Explanation of Provision

The bill amends section 174(b) of the Trade and Tariff Act of 1984 to provide for the third-year reduction to 4.9 percent ad valorem for such watch glasses.

c. Miscellaneous corrections (sec. 1595(3), (4), (5), (6), (7), and (8) of the bill)

The bill corrects paragraph designations and number and statutory references in various sections of the Trade and Tariff Act of 1984.

6. Amendments to the Caribbean Basin Economic Recovery Act (sec. 1596 of the bill, sec. 213 of the Caribbean Basin Economic Recovery Act, and sec. 235 of the Trade and Tariff Act of 1984)

Present Law

Section 235 of the Trade and Tariff Act of 1984 amended section 213(a) of the Caribbean Basin Economic Recovery Act (CBI) to allow products of a beneficiary country to be processed in a bonded warehouse in Puerto Rico after being imported directly from such country and be eligible for duty-free treatment under the CBI upon withdrawal from warehouse if they meet the rule-of-origin requirements set out in paragraph (1)(B) of section 213(a).

Explanation of Provision

The bill corrects a reference to a wrong Tariff Schedules item in section 213(f)(5)(B) of the Caribbean Basin Economic Recovery Act and clarifies that products entering Puerto Rico directly from *any* CBI beneficiary country, not merely the country of manufacture, should quality for entry under bond.

7. Conforming Amendments Regarding Customs Brokers (sec. 1596 of the bill, Title 28 of the United States Code, and sec. 212(b) of the Trade and Tariff Act of 1984)

The bill makes corrections to conforming amendments made by section 212(b) of the Trade and Tariff Act of 1984 in Title 28 of the U.S. Code to cross-references in the Tariff Act of 1930 relating to

customs brokers and deletes an incorrect reference in section 1581(g)(1) of Title 28.

8. Special Effective Date Provisions for Certain Articles Given Duty-Free Treatment Under the Trade and Tariff Act of 1984 (sec. 1596 of the bill and secs. 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984)

Present Law

Sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984 were made effective 15 days after enactment because the provisions providing for retroactive application of such provisions were inadvertently omitted from the Act.

Explanation of Provision

The bill provides for the retroactive application of sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984.

1. Minimum Participation, Vesting, and Benefit Accrual Standards (sec. 1601(a) of the bill, sec. 203(c) of ERISA, and secs. 402 and 411 of the Code)

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (Code sec. 401(a)), then (1) a trust under the plan generally is exempt from Federal income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are accorded special long-term capital gain or 10-year income averaging treatment, and (4) certain plan distributions may be rolled over, tax-free, to an individual retirement account (IRA) or to another qualified plan.

Under a pension plan (including a profit-sharing or stock bonus plan), benefits are provided to plan participants under formulas that determine the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is nonforfeitable. Accordingly, such plans provide rules for determining whether an employee is a plan participant (the participation rules), for determining the portion of the benefit that has been earned (the benefit accrual rules), and for determining the nonforfeitable percentage of a participant's benefit (the vesting schedule).

Under present law, a pension plan plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the formula under which plan benefits are accrued, and to the vesting schedule. The participation standards limit exclusions based on the age and period of service completed by an employee.[13] The benefit accrual standards are based upon the number of years of plan participation. The vesting standard generally is based upon the number of years of service with the employer completed by the employee.

a. Break-in-service rules

Present Law

In general, all years of service with the employer maintaining a pension plan are taken into account for purposes of counting the number of years of plan participation. No credit need be provided, however, for periods during which an employee is considered to

[13] In addition, the Code provides participation rules for qualified plans. These rules are designed to require that qualified plans provide participation to a broad cross-section of employees.

have a break in service. In some cases, an employee who returns to work for an employer after a break in service may lose credit for pre-break service.

Pension plans often provide deferred vesting with respect to benefits derived from employer contributions. In general, all years of service with the employer maintaining a plan are taken into account in determining the level of an employee's vested benefits.

In the case of a nonvested participant, years of service with the employer or employers maintaining the plan before any period of consecutive one-year breaks in service are required to be taken into account after a break in service, unless the number of consecutive one-year breaks in service equals or exceeds the greater of (1) five years, or (2) the aggregate number of years of service before the consecutive one-year breaks in service.

In addition, in the case of a participant in a defined contribution plan or in a defined benefit pension plan funded solely by certain insurance contracts, years of service after a break in service are counted for purposes of determining the vested percentage of the participant's accrued benefit derived from employer contributions before the break in service, unless the participant incurs at least five consecutive one-year breaks in service.

In a class-year plan, employees' rights to benefits attributable to contributions made on their behalf with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contributions were made.

The Act did not explicitly conform the expanded break-in-service rules with the rules regarding the taxation of lump sum distributions. Thus, if an employee separates from service and receives a distribution prior to the time at which he incurs five consecutive one-year breaks in service, the potential increase in vesting that might occur if the employee returned to service may make the distribution ineligible for special 10-year income averaging tax treatment (sec. 402(e)).

Explanation of Provision

Effective for contributions made for plan years after enactment, the bill generally provides that the break-in-service standards of the Code and ERISA applicable to class-year plans are to be conformed to the break-in-service rules provided for other types of plans. Under the bill, a class-year plan generally is to provide that 100 percent of each participating employee's right to benefits derived from employer contributions for a plan year (the contribution year) is to be nonforfeitable as of the close of the fifth plan year of service (whether or not consecutive) with the employer following the contribution year. Under the bill, a plan year is a plan year of service with the employer if the participant has not separated from service with the employer as of the close of that year.

The bill provides that if a participant incurs 5 consecutive one-year breaks in service before the completion of 5 plan years of service with respect to a contribution year, then the plan may provide that the participant forfeits any right to benefits derived from the employer contributions for the contribution year.

The provision is effective for contributions made for plan years beginning after the date of enactment, except that the provision is not effective with respect to a collectively bargained plan until the applicable effective date of the Act for that plan.

In addition, the bill conforms the rules regarding the taxation of lump sum distributions to the break-in-service rules. Under the bill, in determining whether any distribution payable on account of separation from service is a lump sum distribution, the balance to the credit of the employee is to be determined without taking into account any increase in vesting that could occur if the employee is reemployed by the employer. Under the bill, however, if the employee is actually reemployed by the employer and the nonforfeitable interest of the employee in the amount of the pre-break accrued benefit is thereby increased, then the reduction in tax attributable to the treatment of the distribution as a lump sum distribution is to be recaptured as provided by Treasury regulations.

b. Maximum age requirement

Present Law

The Act reduced from 25 to 21 the maximum age requirement that a pension plan may impose as a condition of plan participation. Thus, under the Act, a pension plan generally may not require, as a condition of participation, completion of more than one year of service or attainment of age greater than 21 (whichever occurs later). The Act did not lower the maximum age requirement applicable to simplified employee pensions (SEPs).

Explanation of Provision

The bill reduces from 25 to 21 the maximum age requirement that a SEP may impose as a condition of plan participation. Thus, a SEP may not require, as a condition of participation, attainment of an age greater than 21 or the performance of services for more than three of the immediately preceding five calendar years (whichever occurs later).

2. Survivor Benefit Requirements (sec. 1601(b) of the bill, sec. 205 of ERISA, and secs. 401 and 417 of the Code)

a. Coordination between qualified joint and survivor annuity and qualified preretirement survivor annuity

Present Law

A pension plan (including certain profit-sharing or stock bonus plans) is required generally to provide automatic survivor benefits with respect to an employee who was a participant in the plan if the participant's spouse survives the participant. In the case of a participant who retires under the plan, the survivor benefit is to be provided in the form of a qualified joint and survivor annuity. In the case of a vested participant who dies before the annuity starting date (the first period for which an amount is received as an annuity, whether by reason of death or disability, under the plan),

the survivor benefit is to be provided in the form of a qualified preretirement survivor annuity.

A vested participant is any participant (whether or not still employed by the employer at the time of death) who has a nonforfeitable right to any portion of the accrued benefit under the plan derived from employer contributions. If a plan permits a surviving spouse to elect to have survivor benefits paid in a form other than an annuity, then the value of the alternative form of benefits is not to be less than the actuarial equivalent of the required survivor benefit.

Explanation of Provision

The bill provides that a qualified joint and survivor annuity is to be provided in the case of a married participant who does not die before the annuity starting date unless the benefit is waived (with spousal consent) in favor of another benefit. As under present law, the annuity starting date is the date on which an amount, which may include retirement benefits and disability benefits, is first received as an annuity (whether or not the annuity is a life annuity). Accordingly, under the bill, the qualified preretirement survivor annuity rules apply in the case of death before the annuity starting date and the qualified joint and survivor annuity rules apply in the case of death on or after the annuity starting date.

Under the bill, if a participant dies before an amount is received as an annuity, the participant's spouse generally is entitled to a qualified preretirement survivor annuity unless that benefit has been waived.

Similarly, under the bill, if a participant dies after attaining the normal retirement age under a plan but before the annuity starting date, a qualified preretirement survivor benefit is to be provided to the participant's spouse unless the benefit has been waived.

b. Transferee plan rules

Present Law

The provisions requiring survivor benefits generally apply to any pension plan. However, the survivor benefit requirements do not apply with respect to a participant under a profit-sharing or stock bonus plan if (1) the plan provides that the nonforfeitable accrued benefits of a deceased participant will be paid to the surviving spouse of the participant (or to another beneficiary if the surviving spouse consents or if there is no surviving spouse), (2) under a plan that provides for benefits in the form of a life annuity, the participant does not elect payment of benefits in the form of a life annuity, and (3) with respect to the participant, the plan is not a direct or indirect transferee of a plan required to provide survivor benefits. A plan is a transferee of a plan required to provide survivor benefits if the plan (1) receives a direct transfer of assets in connection with a merger, spinoff, or conversion of a plan that is subject to the survivor benefit requirements, or (2) receives a direct transfer of assets solely with respect to the participant. Also, a plan is a transferee plan with respect to a participant if it receives amounts from a plan that is a transferee plan with respect to that partici-

pant. A plan is not a transferee plan if it receives rollover contributions by a participant from another plan.

Explanation of Provision

The bill includes two provisions relating to the transferee plan rules. First, the bill clarifies that a plan is not to be considered a transferee plan on account of a transfer made before January 1, 1985. Accordingly, a plan would not be treated as a transferee merely because of a transfer completed before January 1, 1985.

In addition, the bill clarifies that if separate accounts are properly maintained for the transferred assets and investment yield attributable to those assets, then the transferee plan rule applies only with respect to benefits attributable to the transferred assets. Under the bill, if separate accounts are not maintained for transferred assets with respect to an employee, then the survivor benefit requirements apply to all benefits payable with respect to the employee under the plan.

c. Qualified preretirement survivor annuity in case of terminated vested participant

Present Law

A qualified preretirement survivor annuity is defined as an annuity for the life of the surviving spouse of the participant. The amount of each payment under a qualified preretirement survivor annuity is not to be less than the payment that would have been made under a qualified joint and survivor annuity if (1) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's death, and (2) in the case of a participant who dies on or before the earliest retirement age under the plan, the participant had separated from service on the date of death, survived until the earliest retirement age, and retired at that time with a qualified joint and survivor annuity.

Explanation of Provision

The bill clarifies that, in the case of a participant who separates from service prior to death, the amount of the qualified preretirement survivor annuity is to be calculated by reference to the actual date of separation from service, rather than the date of death. Thus, for purposes of calculating the qualified preretirement survivor annuity, a participant is not to be considered to accrue benefits after the date of separation from service.

d. Spousal consent requirements

Present Law

Under present law, the consent of a participant's spouse is required for an election to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity. This consent is to be given in writing at the time of the participant's election, and the consent is to acknowledge the effect of the election. A con-

sent is not valid unless it is witnessed by a plan representative or a notary public. Any consent obtained is effective only with respect to the spouse who signs it.

A spouse's consent to waive a death benefit under a profit-sharing or stock bonus plan not otherwise subject to the survivor benefit requirements is to be made in the same manner as the spousal consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity. The Act does not require the spousal consent under an exempt profit-sharing or stock bonus plan to be made at the same time as spousal consent under a plan subject to the survivor benefit requirements. Thus, the Act generally does not require that spousal consent be obtained to make a distribution (other than the payment of benefits in the form of a life annuity) to a participant under a profit-sharing or stock bonus plan.

A plan may immediately distribute the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the present value of the benefit does not exceed $3,500. No distribution may be made after the annuity starting date unless the participant and the participant's spouse (or the surviving spouse of the participant) consent in writing to the distribution. Thus, a plan could permit a participant and the participant's spouse to change the form of benefits received under the plan after the annuity starting date.

In addition, if the present value of the benefit under the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value.

Present law does not preclude a plan from permitting a spouse to make a conditional waiver of a survivor benefit. For example, a plan could offer a spouse the right to waive a qualified preretirement survivor annuity, effective only if the present value of the annuity is less than another death benefit payable to the spouse under the plan.

Explanation of Provision

Under the bill, a spouse's consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity is not valid unless the consent (1) names a designated beneficiary who will receive any survivor benefits under the plan or (2) acknowledges that the spouse has the right to limit consent only to a specific beneficiary and the spouse voluntarily elects to relinquish such right. The spousal consent form is to contain such information as may be appropriate to disclose to the spouse the rights that are relinquished. If the consent names a designated beneficiary, then any subsequent change to the beneficiary designation is invalid unless a new consent is obtained from the participant's spouse. A plan that permits a waiver by the spouse may not restrict the spouse's ability to waive by requiring that any such waiver not designate a specific beneficiary.

Similar rules apply to a spousal consent obtained to waive a death benefit under a profit-sharing or stock bonus plan that is not otherwise subject to the survivor benefit requirements.

In addition, under the bill, in the case of a participant's benefit that is not exempt from the survivor benefit requirements, a plan is to provide that no portion of the accrued benefit of the participant may be used as security for any loan unless the participant's spouse (determined at the time of the loan) consents to the use of the accrued benefit as security. If the spouse gives consent, then the plan is not prevented by the spousal consent rules from realizing its security interest in the event of a default on the participant's loan.

In the case of a plan that is not subject to the survivor benefit provisions (if certain requirements are satisfied), the bill clarifies that the determination of a participant's nonforfeitable accrued benefit that is payable to the participant's surviving spouse upon the participant's death is reduced by any security interest held by the plan by reason of a loan outstanding to the participant. Consequently, in the case of a profit-sharing or stock bonus plan, the plan will not be treated as failing to meet the survivor benefit requirements if the participant's benefit is used as security for a loan and spousal consent is not obtained for the use of the accrued benefit as security.

The consent of a spouse in writing to a loan under the plan is to be made in the same manner as spousal consent to waive a survivor benefit.

For example, assume that a spouse consents to a pledge of the participant's account balance as security for a loan from the plan. Under the plan, the plan administrator is to realize on the security for the loan if it is not repaid by the time the employee separates from service. Because the spouse consented to the loan, the plan is not prevented from using the security (i.e., the account balance) to recover the amount due on the loan. In addition, if the participant had remarried after the loan was made but before the plan realized on its security, then the consent of the first spouse would continue to be effective for purposes of determining the plan's ability to realize its security interest.

The bill clarifies that, for purposes of determining who is a vested participant subject to the survivor benefit provisions, a participant's accrued benefit includes accrued benefits derived from employee contributions.

The bill provides that, in the case of a defined contribution plan subject to the survivor benefit requirements, the participant's vested account balance is used for purposes of determining the amount of the qualified preretirement survivor annuity.

Further, the bill clarifies that the election period and notice requirements with respect to spousal consent apply in the case of spousal consent (1) to waive a survivor benefit, (2) to permit the participant's accrued benefit to be pledged as security for a loan, (3) to permit a cash out of amounts not exceeding $3,500 after the annuity starting date, and (4) to permit a cash out of amounts in excess of $3,500.

Effective Dates

The provision relating to spousal consents to beneficiary designations is effective for consents given after the date of enactment of the bill.

The provision relating to accrued benefits pledged as security for a loan is effective for loans made after April 18, 1985. In addition, any accrued benefits pledged as security for a loan prior to April 19, 1985, are exempt from the requirement that spousal consent be obtained. Accordingly, in the case of a pledge made before April 18, 1985, a plan is not required to obtain the consent of any spouse of a participant before it applies the benefit against the loan. Finally, any loan that is revised, extended, renewed, or renegotiated after April 18, 1985, is treated as a loan made (and security pledged) after April 18, 1985.

e. Notice requirement for individuals hired after age 35

Present Law

A plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. This notice is to be provided within the period beginning on the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35. This notice is to be comparable to the notice required with respect to the qualified joint and survivor annuity. The qualified preretirement survivor benefit coverage may become automatic prior to the time that the participant is entitled to decline such coverage.

Explanation of Provision

The bill provides that the period for giving notice to a participant who is hired after age 35 is a reasonable period after the date of hire. Treasury regulations could permit a reasonable period of time to include a period up to the later to occur of (1) the time the participant vests in any accrued benefits derived from employer contributions under the plan or (2) the expiration of 3 years after the participant's date of hire.

f. Clarification of rule for subsidized benefits

Present Law

Under the Act, a plan is not required to provide notice of the right to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the plan fully subsidizes the cost of the benefit. A plan fully subsidizes the cost of a benefit only if the failure to waive the benefit by a plan participant does not result in either (1) a decrease in any plan benefits with respect to the participant, or (2) in increased plan contributions by the participant.

Explanation of Provision

The bill clarifies that the exception to the notice requirement only applies if the plan does not permit a participant to waive a fully subsidized benefit.

g. Clarification of annuity starting date

Present Law

Present law provides that the annuity starting date means the first period for which an amount is received as an annuity (whether by reason of death or disability).

Explanation of Provision

Under the bill, the definition of the annuity starting date is amended to provide that, in the case of a benefit not payable in the form of an annuity, the annuity starting date is the date on which the payment of benefits commences.

3. Qualified Domestic Relations Orders (sec. 1601(c) of the bill, sec. 206 of ERISA, and secs. 502 and 414(p) of the Code)

Under present law, neither ERISA nor the Code treats a qualified domestic relations order as a prohibited assignment or alienation of benefits under a pension plan. In addition, the Act creates an exception to the ERISA preemption provision only with respect to these orders.

A "qualified domestic relations order" is a domestic relations order that (1) creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a pension plan, and (2) meets certain other requirements. A domestic relations order is any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of the participant, and is made pursuant to a State domestic relations law (including community property law). An alternate payee includes any spouse, former spouse, child, or other dependent of a participant who is recognized by a qualified domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to the participant.

a. Tax treatment of divorce distributions

Present Law

Special rules are provided for determining the tax treatment of benefits subject to a qualified domestic relations order. For purposes of determining the taxability of benefits, the alternate payee is treated as a distributee with respect to payments received from or under a plan.

In addition, net employee contributions (together with other amounts treated as the participant's investment in the contract)

are apportioned between the participant and the alternate payee under regulations prescribed by the Secretary of the Treasury.

Explanation of Provision

The bill provides that the special rules for determining the taxability of benefits subject to a qualified domestic relations order apply only to distributions made to an alternate payee who is the spouse or the former spouse of the participant. Thus, distributions to a spouse or former spouse generally will be included in the gross income of the spouse or former spouse. Under the bill, however, a distribution to an alternate payee other than a spouse (e.g., a child) is generally to be includible in the gross income of the participant.

b. Determination by plan administrator

Present Law

The administrator of a plan that receives a domestic relations order is required to notify promptly the participant and any other alternate payee of receipt of the order and the plan's procedures for determining whether the order is qualified. In addition, within a reasonable period after receipt of the order, the plan administrator is to determine whether the order is qualified and notify the participant and alternate payee of the determination.

During any period in which the issue of whether an order is a qualified order is being determined (by the plan administrator, by a court of competent jurisdiction, or otherwise), the plan administrator is to defer the payment of any benefits in dispute. These deferred benefits are segregated either in a separate account in the plan or in an escrow account.

If the order is determined to be a qualified domestic relations order within 18 months after benefits are first deferred, then the plan administrator is to pay the segregated amounts to the persons entitled to receive them. If the plan administrator determines that the order is not a qualified order or, after the 18-month period has expired, has not resolved the issue of whether the order is qualified, the segregated amounts are paid to the person or persons who would have received the amounts if the order had not been issued.

Explanation of Provision

The bill makes it clear that the 18-month period during which benefits may be deferred begins with the date on which any payments would, but for the deferral, be required to commence. Accordingly, if a payment is deferred pending the resolution of a dispute, then that payment and each other payment that is deferred within the next 18 months because of the dispute are to be segregated. If the dispute is not resolved 18 months after the first payment is deferred, then all payments deferred during the 18-month period with respect to the dispute are to be paid to the persons who would have received them if the order had not been issued.

c. Coordination with qualified plan requirements

Present Law

A plan is not treated as failing to satisfy the requirements of section 401(a) or 401(k) of the Internal Revenue Code that prohibit payment of benefits prior to termination of employment solely because the plan makes payments to the alternate payee in accordance with a qualified domestic relations order. However, it is unclear whether payments made to an alternate payee pursuant to a qualified domestic relations order prior to the date at which the participant would have attained the earliest retirement age would violate these qualification requirements.

Explanation of Provision

The bill makes it clear that a plan is not treated as failing to satisfy the qualification requirements of section 401(a) or 401(k) of the Internal Revenue Code (prohibiting payment of benefits prior to termination of employment) solely because the plan makes payment to the alternate payee, even if the payments are made with respect to a participant who has not separated from service, and they commence before the participant has attained the earliest retirement age under the plan. This exception applies, however, only if the present value of the benefit to be paid to an alternate payee does not exceed $3,500.

In addition, the bill authorizes the Secretary of the Treasury to issue such regulations as may be necessary to otherwise coordinate the Code provisions affecting qualified domestic relations orders (sections 401(a)(13)(B) and 414(p)), and the regulations issued by the Secretary of Labor thereunder with other Code provisions affecting qualified plans. The Secretary of Labor has authority to issue regulations under the qualified domestic relations order provisions of ERISA, and the Code (secs. 401(a)(13)(B) and 414(p)), and the bill does not affect the authority of the Secretary of Labor to prescribe such regulations.

4. Notice of Rollover Treatment (sec. 1601(d) of the bill and secs. 402 and 6652 of the Code)

Present Law

When the administrator of a qualified plan makes a qualifying rollover distribution, the administrator is to provide notice to the recipient that (1) the distribution will not be taxed currently to the extent transferred to another qualified plan or an IRA, and (2) the transfer must be made within 60 days of receipt in order to qualify for this tax-free rollover treatment.

Failure of the plan administrator to give the required notice of rollover treatment results in imposition of a $10 penalty for each failure (up to $5,000) for each calendar year. This penalty does not apply if the failure is shown to be due to reasonable cause and not to willful neglect.

Explanation of Provision

The bill makes it clear that a plan administrator is to provide notice when making any distribution eligible for rollover treatment. Thus, for example, notice is to be provided when a distribution eligible for rollover treatment pursuant to the partial rollover rules is made.

5. Transitional Rules

Present Law

The qualified joint and survivor annuity and qualified preretirement survivor annuity provisions added by the Act generally are effective for plan years beginning after December 31, 1984.

The new rules for qualified joint and survivor benefits and preretirement survivor benefits apply to any participant who performs at least one hour of service or has at least one hour of paid leave under the plan on or after the date of enactment. In addition, a qualified preretirement survivor annuity must be provided (unless another form of benefit is elected) in the case of any participant who (1) performs at least one hour of service or has at least one hour of paid leave under the plan after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the first day of the first plan year to which the provisions apply.

The Act immediately imposes certain survivor benefit requirements with respect to participants who die before the plan is required to be amended to comply with the Act. During this transition period, it appears that a plan is required to make payments to a surviving spouse notwithstanding the possible contractual claims of other designated beneficiaries. However, it is unclear whether the survivor benefits required by the Act reduce the total death benefits payable to other designated beneficiaries.

Explanation of Provision

The bill clarifies the application of the transitional rule relating to qualified pre-retirement survivor benefits in situations in which the participant had designated a beneficiary other than the participant's spouse. Under the bill, the total death benefit payable to any beneficiary with respect to an individual who (1) performs at least one hour of service under the plan after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the effective date of the Act, may be reduced by the amount payable to the participant's surviving spouse pursuant to the transition rule.

However, the bill also permits the surviving spouse to waive the right to receive the death benefit. Under the bill, if it is made on or before the close of the first plan year to which the Act applies, then the waiver is not to be treated as a transfer for purposes of Federal gift taxes or as a prohibited assignment or alienation for purposes of ERISA or the Code. In addition, death benefits waived by the surviving spouse during this period would not be includible in the spouse's income. Such benefits would be includible in the gross income of the recipient.

VI. BUDGET EFFECTS

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effect on the budget of the bill (H.R. 3838) as reported by the committee.

Revenue Effect

The detailed estimated revenue effect of the bill is shown in Part III of this report. The bill is estimated to reduce tax revenues by $364 million over the five-year period, fiscal years 1986–1990.

The following is a year-by-year summary revenue effect of the bill on individual, corporate, excise, and estate and gift tax revenues.

SUMMARY REVENUE EFFECT OF H.R. 3838 FISCAL YEARS 1986–90

(Millions of dollars)

	1986	1987	1988	1989	1900
Individual	−8,322	−25,415	−34,684	−34,997	−36,400
Corporate	15,574	22,943	27,105	32,039	41,201
Excise	64	105	112	131	145
Estate and gift	12	9	5	5	4
Total	7,328	−2,358	−7,462	−2,822	4,950

Outlay Effect

The following provisions of the bill have budget outlay effects:

[Fiscal years (millions of dollars)]

	1986	1987	1988	1989	190
Earned income credit (refundable amount) (sec. 111)	40	1,177	2,025	2,275	2,555
Attorney's fees (sec. 1315)	(1)	(1)	(1)	(1)	(1)
Adoption assistance program (sec. 1407)	(2)	(2)	(2)	(2)	(2)

[1] This is estimated to be less than $5 million per year.

[2] This provision is expected to involve outlay amounts similar to the estimated revenue increase from repeal of the itemized deduction for certain adoption expenses (sec. 134 of the bill).

VII. VOTE OF THE COMMITTEE AND OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

A. Vote of the Committee

In compliance with clause 1(l)(2)(B) of Rule XI of the House of Representatives, the following statement is made concerning the vote of the committee on the motion to report H.R. 3838. The bill was ordered favorably reported by a roll call vote of 28 ayes and 8 noes.

B. Other Matters

In compliance with clauses (2)(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 3838.

Oversight Findings

With respect to subdivision (A) of clause (2)(l)(3) (relating to oversight findings), the committee advises that it was a result of the committee's comprehensive review of tax reform proposals during the past year (see legislative background in Part I of this report regarding the hearing and markup schedule of the committee and subcommittees relating to tax reform) that the committee concluded it is appropriate to report a comprehensive tax reform bill. (See also Part II of this report for more details on the overall reasons for the need to revise and reform the Internal Revenue Code.)

Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), the committee states that the changes made by the bill as reported involve a net decrease in tax expenditures (individual and corporate income tax provisions) for fiscal years 1986–1990, of $327 billion, as follows:

NET DECREASE IN TAX EXPENDITURES

[Fiscal years (billions of dollars)]

	1986	1987	1988	1989	1990
Individual income tax	6.1	20.9	22.0	26.6	31.8
Corporate income tax	19.5	36.8	47.1	53.3	62.9
Net changes in tax expenditures [1]	25.6	57.8	69.1	79.9	94.7

[1]These estimates are based on the new tax rate schedules for the bill for individuals and corporations, as included in Table IV-2 in Part IV of this report. Changes in the basic tax rate structure (individual tax rates, personal exemptions, and standard deduction, and basic corporate tax rate) are not considered as affecting tax expenditures. The graduated tax rate for small corporations is counted as a tax expenditure. Changes in excise taxes and estate and gift taxes are not considered to involve tax expenditures under the present definition of tax expenditures.

New Budget Authority

With respect to subdivision (B) of caluse 2(l)(3), the committee states that the changes made by the bill as reported involve increased budget authority (with respect to the increase in the refundable earned income credit) of $40 million in fiscal year 1986, $1,177 million in fiscal year 1987, $2,025 million in fiscal year 1988, $2,275 million in fiscal year 1989, and $2,555 million in fiscal year 1990. Also, the bill involves budget outlays of less than $5 million per year for the attorney's fees provision and amounts relating to the new adoption assistance program authorized by section 1407 of the bill, similar to the revenue gain from the repeal of the adoption expense deduction under section 134 of the bill.

Congressional Budget Office Estimates

With respect to subdivision (C) of clause 2 (l)(3), the committee advises that no statement has been received from the Director of the Congressional Budget Office concerning the provisions of this bill as reported.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted by the Committee on Government Operations regarding the subject matter of the bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the provisions of the bill are not expected to produce any significant change in the general price level. The individual income tax provisions reduce the overall burden of taxes on individuals eliminate about 6 million lower income filers from income tax liability, and reduce the marginal tax rates, thereby increasing the after-tax return to additional work effort and increased productivity. Business activity is affected by a number of interrelated changes which include lower corporate income tax rates and a considerably broader corporate income tax base. Although some businesses may be affected adversely, the general nature of these tax law changes is to eliminate or reduce special or narrow tax incentives that have favored specific business activity or industries. These tax changes will establish a substantially more equal competitive field for all businesses so that business economic decisions will be made in terms of their inherent profitability instead of primarily on the basis of tax advantages.

VIII. DISSENTING VIEWS OF THE HON. JOHN J. DUNCAN, HON. BILL ARCHER, HON. GUY VANDER JAGT, HON. PHILIP M. CRANE, HON. BILL FRENZEL, HON. RICHARD T. SCHULTZE, HON. W. HENSON MOORE, HON. CARROLL A. CAMPBELL, HON. WILLIAM M. THOMAS, HON. HALDAUB, AND HON. JUDD GREGG

There is a Republican Alternative to H.R. 3838, and we believe it is preferable—by far!

We urge our colleagues, on both sides of the political aisle, to take a close look at it. We think it will gain favor by comparison, and that its broad appeal will persuade many Members, with diverse concerns, to vote for it on the Floor. (The Republican Alternative will be offered as an amendment in the nature of a substitute to H.R. 3838, and will be printed in statutory form, along with a detailed explanation, in the Congressional Record of December 6, 1985.)

The Republican Alternative was crafted carefully to make improvements where needed and desired, and to leave alone those provisions of tax law which do not need to be changed or should be considered for deletion or addition at another time, in another context.

The Republican Alternative has President Reagan's blessing, as a starting point in the legislative process. In a statement issued December 4, 1985, the President said: "More can and must be done to broaden the tax base, reduce tax rates further, and lower the cost of capital, so we can strengthen economic growth and personal opportunity for every American. Any legislation that ends up retarding economic growth, and thereby diminishing the number of jobs upon which American families depend, is not what we mean by 'tax reform.' "

The President is absolutely right, and that is the central thrust of the Republican Alternative. One of the greatest advantages of our Alternative is its positive macroeconomic impact, as contrasted to H.R. 3838.

For example, the Republican Alternative is designed in large part to enhance, not diminish, our country's ability and capacity to compete in world marketplaces. In the face of alarming trade deficits and a sagging ability of U.S. companies to compete throughout the world, H.R. 3838 would decimate national capital formation incentives and make even more complex the taxation of U.S. companies doing business abroad. The Republican Alternative reverses the trend on capital formation incentives, in recognition that proposed changes with respect to the taxation of U.S. companies doing business abroad, no matter how well intentioned, are clearly ill timed. Consequently, the Republican Alternative includes only modest, generally non-controversial changes.

H.R. 3838 reverses completely the capital formation incentives enacted in President Reagan's Economic Recovery Tax Act of 1981. Our Alternative moderates this shift by (1) retaining a 5% investment tax credit on domestically produced manufacturing equipment, (2) setting the corporate alternative minimum tax rate at 20% (25% in the Committee Bill) so as to avoid penalizing marginally profitable capital intensive businesses, (3) providing full indexing (by 1991) of depreciation (as in the President's Proposal), and (4) providing for a 28-year recovery period on structures (also as in the President's Proposal). In addition, the Republican Alternative retains the current law individual capital gains tax rate of 20%. It would be 22% under H.R. 3838.

H.R. 3838 also provides a top corporate marginal rate of 36 percent, phased-in over two years. The Republican Alternative, taking into account the importance of long-term corporate rate reduction for economic growth and efficiency, provides a phase-in corporate rate reduction to 33 percent (the rate provided in the President's Proposal) by 1991.

The Republican Alternative should be more attractive to all Members, both Democratics and Republicans, for these additional reasons:

H.R. 3838 has an anti-family bias because it reduces a taxpayer's itemized deductions in relation to the number of children a taxpayer has. For ecampie, if a taxpayer has 3 dependents, his or her itemized deductions are reduced by $1,500; 5 dependents, by $2,500; 7 dependents (i.e., a family of 5 children), by $3,500. The Republican Alternative reserves this anti-family bias by providing a $2,000 personal exemption per dependent while imposing no reduction in the itemized deduction related to the number of children of a taxpayer. The Republican Alternative provides a full $2,000 personal exemption for *every taxpayer* in the first two brackets—approximately 90 percent of all taxpayers—with a diminished personal exemption for higher income, high marginal rate taxpayers.

H.R. 3838 provides delayed marginal rate reductions for individuals, phasing them in over two years to reduce the top individual marginal rate to 38%. The Republican Alternative provides an immediate reduction of the top marginal rate to *37 PERCENT* effective January 1, 1986. That top rate drops to 35% in 1991.

H.R. 3838 also has an anti-savings, pro-consumption bias, despite the fact that Americans are currently saving at the slowest rate in 35 years. The Republican Alternative provides a full $2,000 spousal IRA, as in the President's Proposal. It allows an annual $12,000, section 401(k) contribution to for-profit employers *and* private nonprofit employers; and, it discourages consumer debt through limits on deductibility.

H.R. 3838 provides extensive, and in some cases incongruous, modifications to the existing maze of statutory tax restrictions governing our nation's private retirement system. These are poorly timed in view of (1) the extensive revisions which this area of law has experienced, in three separate pieces of legislation, since 1982, and (2) the comprehensive review of retirement income policies now underway by the Subcommittees on Social Security and Oversight of the Committee on Ways and Means and other committees of the Congress. Recognizing the integral role which the private re-

tirement system plays in providing retirement income security, we believe review and revision of these provisions should be delayed. The Republican Alternative follows this more prudent course by including *only* minimal changes in this area, thus leaving for another day a comprehensive review of this important area of tax and income retirement policy.

H.R. 3838 would impose additional, and in some cases confusing, new restrictions on both public purpose and private purpose tax-exempt bond financing. Because the Congress imposed substantial new restrictions on the use of tax-exempt bonds in 1984, the Republican Alternative generally retains current law.

Finally, H.R. 3838 provides a very tough minimum tax for corporations and individuals, but still allows certain taxpayers to have net income for a current year, yet pay no tax. Permitting such a situation to continue both undermines the public's confidence in the fairness of our tax system and is inconsistent with the concept that each individual and business earning income in a given year should help participate in the cost of government. The Republican Alternative contains a Super Minimum Tax designed to avoid this result by requiring all taxpayers to pay some minimum amount of tax in any year in which they earn income.

In summary, we believe that a careful and thorough appraisal of The Republican Alternative will show very clearly its superiority over H.R. 3838. We hope that this will translate into majority support when the vote occurs on the Floor of the House.

JOHN J. DUNCAN.
BILL ARCHER.
GUY VANDER JAGT.
PHILIP M. CRANE.
BILL FRENZEL.
RICHARD T. SCHULZE.
W. HENSON MOORE.
CARROLL A. CAMPBELL.
WILLIAM M. THOMAS.
HAL DAUB.
JUDD GREGG.

IX. Additional Dissenting Views of Hon. Bill Frenzel

Tax Bill

The Ways and Means Committee worked hard to bring out a Tax Reform Bill. On the basis of hours worked and energy expended, each Member should get an A. On the same basis, the Chairman should get a gold star.

But the final standard is the product, not the energy expended to produce it. The Committee's product, H.R. 3838, falls far short of any reasonable Tax Reform standard.

It is anti-growth. Our country can tolerate a lot of mischief in the name of Tax Reform, but no industrial democracy should have to induce recession for Tax Reform. One of the President's goals was growth. This bill, according to economic analysis, retards growth.

It reduces incentives for savings and investment. The U.S. has the lowest personal savings rate in the industrialized world. It must borrow abroad to finance its own economy. If this Bill passes, it will cause reduced savings for 401(k) plans and qualified pension plans. It rejects the President's spousal IRA. It stretches depreciation and repeals the investment tax credit.

It certainly makes American industries non-competitive. Our manufacturing companies are having trouble holding markets abroad and even at home. The substantial, and unnecessarily abrupt, changes in capital recovery systems will have a serious, harmful effect.

It ruins America's incentive to sell abroad. Every tax incentive to keep or expand American presence abroad is reduced. The foreign tax credit, the deferrals, the FSC, and Section 911, all are reduced. The latter two are savaged again by the minimum tax.

The Bill fails to achieve the President's marginal tax rate targets. It exceeds "the lines drawn in the sand" in individual rates, corporate rates, and capital gains rates. It also does not deliver the $2,000 personal exemption, one of the few Tax Reform features which has captured the interest of the public.

Another of the President's goals was simplicity. In rejecting the repeal of poipular credits to lure more filers to the short forms, and in accepting many back-scratching amendments to assist particular regions, sectors, or companies, the Committee has made the Tax Code far more complex. Simplicity in this Bill has become a sick joke.

It took the Committee only 1,363 pages to write its "simplification" Bill. That says it all!

The Committee added unnecessary, large sections of complex law. In pensions, and again in trusts, there are terribly complicated "reforms" which save no money buy may cause employers to drop plans, and employees to have no pension coverage.

There is a wide array of individual items which confuse the Tax Code, or make it unfair. One which raises interest penalties on under-withheld taxpayers is particularly unfair, and mean spirited. Others, which attack particular industries like insurance and banking, or travel and entertainment expenses are no better. The treatment given to charities is also not consistent with American values.

The problem may have been that the President bit off more than Congress could chew. His plan had more scope than the Committee could handle effectively.

Whatever the problem, the Bill flunks the test of Tax Reform. It is so far off the Tax Reform track that it is irreparable. Certainly the Republican substitute is vastly superior, but it had to be put into terms and form similar to the Committee Bill. That means it is, while infinitely better than the Committee Bill, still inferior to current law.

When a Committee misses the target so widely as this, it has no choice but to start over.

BILL FRENZEL.

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